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83-897

No. .....

In the Supreme Court of the United States

OCTOBER TERM, 1983

UNITED STATES OF AMERICA,
Respondent,

v.

HARRY S. STONEHILL,
ROBERT P. BROOKS
LOURDES BLANCO STONEHILL,
PACITA C. BROOKS, et al
Petitioners.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI
By LOURDES BLANCO STONEHILL and
PACITA C. BROOKS
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

A. Whether a federal tax lien against a U.S. citizen arising from his foreign source earnings, can attach to and be foreclosed against the vested property of his alien non-resident wife on the theory that the wife cannot "retain the benefit of [his] earnings while avoiding [his] non-beneficial taxes."

B. Whether the attachment to and foreclosure against the vested property of an alien non-resident wife of a U.S. citizen for his federal income tax obligations on his income without consent of the foreign sovereign is indirect and extra territorial taxation of income not taxable directly.

LIST OF PARTIES

United States of America
Harry S. Stonehill
Robert P. Brooks
Lourdes Blanco Stonehill
Pacita C. Brooks
Trammell, Rand, Nathan & Lincoln
Lourdes Blanco Stonehill Childrens' Trust
Elizabeth Ann Stonehill and the Elizabeth Ann Stonehill Trust
Susan Jane Stonehill and the Susan Jane Stonehill Trust
Harry Steven Stonehill, Jr. and the Harry Steven Stonehill, Jr. Trust
Michael Joseph Stonehill and the Michael Joseph Stonehill Trust
Pacita C. Brooks Children's Trust
Mary Jane Brooks Moore
Virginia Mae Brooks
Charles A. Brooks
Richard A. Brooks
Kenneth C. Brooks
Pine Street Management Corporation
Marinship Enterprises, Inc.
The Harroman Company, Inc.
The Makiki Corporation
William W. Saunders
Ira Blaustein
Wells Fargo Bank American Trust Company

Peter O. Mattei
Ben Gromet
Jim Cyrus
Richard N. Rapoport
Sidney P. Rudy
Tierra Ranch, Inc.
Contracts Discount, Inc.
John E. Fort
Julius Barr & Co.
Title Insurance and Trust Company
Sam Steinberg
Irving Sulmeyer
Holexa, S. A.
Petramonte Productions Corporation Establishment
Stonehill Family Trust
Tower Development Corporation
Merriweather Development Corporation
California Street Corporation
Palo Corporation
The Brookstone Corporation
Swiss Bank Corporation
Northwestern Savings and Loan Association
Heath Land Company
Kurt Heath
Nathan Berke
Jane Ratney

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PETITION FOR WRIT OF CERTIORARI
By LOURDES BLANCO STONEHILL and
PACITA C. BROOKS
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Petitioners respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit insofar as that judgment affirmed the Judgment of the District Court

and deprived these non-resident alien petitioners of their spousal rights under the community property laws of their place domicile, The Philippines.

REPORTS OF OPINIONS BELOW

The decision of District Judge Gus J. Solomon appears in *United States* v. *Stonehill*, 420 F.Supp. 46 (C.D. Cal. 1976) (Appendix C).

The United States Court of Appeals for the Ninth Circuit (Judges William T. Canby, William A. Norris, and Stephen Reinhardt) rendered its opinion on April 8, 1983; that opinion has been officially and unofficially reported as follows: *United States* v. *Stonehill*, 702 F.2d 128[illegible] 9th Cir. 1983); 83-1 U.S.T.C., p. 9285; 51 AFTR 2d 83-1152 (Appendix A). On April 21, 1983, taxpayers (Petitioners' husbands) filed a timely Petition for Rehearing and Suggestion For Rehearing En Banc. Supreme Court Rule 20.4. On September 1, 1983, the Ninth Circuit entered its written opinion denying the petition; that opinion has not been reported, officially or unofficially (Appendix B).

An earlier related case concerning most of the same parties but involving different questions of law (propriety of taxpayers' motion to suppress) appears in *Stonehill* v. *United States*, 274 F.Supp. 420 (S.D. Cal. 1967), 405 F.2d 738 (9th Cir. 1968), *reh den.* 405 F.2d 738 (9th Cir. 1969), *cert den.* 395 U.S. 960, 89 S.Ct. 2102, 23 L.Ed. 2d 747, *reh den.* 396 U.S. 870, 90 S.Ct. 39, 24 L.Ed. 2d 125 (1969).

GROUNDS FOR SUPREME COURT JURISDICTION

The District Court for the Central District of California, the District Court for the Northern District of California and the District Court for the District of Hawaii entered judgments on October 14, 1980 (CR 732, 733, 734 respectively). Petitioners filed timely notices of appeal to the United States Court of Appeals for the Ninth Circuit in the District Court for the Central District Court of California on December 5, 1980 (CR 738), in the District Court for the Northern District of California on December 8, 1980 (CR 739), and in the District Court for the District of Hawaii on December 8, 1980 (CR 740). The Ninth Circuit consolidated these appeals on petitioners' motion on January 22, 1981 (CR 754).

The United States Court of Appeals for the Ninth Circuit rendered its judgment affirming the judgments of the district courts on April 8, 1983. *United States* v. *Stonehill*, *supra*, 702 F.2d 1288 (9th Cir. 1983) (Appendix A). Taxpayers, petitioners' husbands, timely filed a Petition for Rehearing and Suggestion for Rehearing En Banc in the Ninth Circuit on April 21, 1983. The Ninth Circuit denied this petition on September 1, 1983 (Appendix B).

28 U.S.C. § 1254(1) confers jurisdiction upon the Supreme Court of the United States to review the judgments herein by writ of certiorari. 28 U.S.C. § 2101(c) provides that a petition for a writ of certiorari shall be filed within ninety days after entry of the judgment of the Ninth Circuit. Supreme Court Rule 20.4 pro-

vides that petitioners shall receive ninety days from the denial of September 1, 1983 within which to file their petition for writ of certiorari.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Constitution of the United States of America, Amendment V:

> "*When prosecution to be by presentment or indictment; double jeopardy; self-incrimination; due process; compensation for property taken for public use.* No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use without just compensation."

Civil Code of the Philippines, Republic Act 386 as amended, Art. 161:

> "SECTION 4. —*Charges Upon and Obligations of the Conjugal Partnership*
>
> "ART. 161. The conjugal partnership shall be liable for:
>
> "(1) All debts and obligations contracted by the husband for the benefit of the conjugal partnership,

and those contracted by the wife, also for the same purpose, in the cases where she may legally bind the partnership;

"(2) Arrears or income due, during the marriage, from obligations which constitute a charge upon property of either spouse or of the partnership;

"(3) Minor repairs or for mere preservation made during the marriage upon the separate property of either the husband or the wife; major repairs shall not be charged to the partnership;

"(4) Major or minor repairs upon the conjugal partnership property;

"(5) The maintenance of the family and the education of the children of both husband and wife, and of legitimate children of one of the spouses;

"(6) Expenses to permit the spouses to complete a professional, vocational or other course. (1408a)"

STATEMENT OF THE CASE

Petitioner Lourdes Blanco Stonehill was at all times relevant herein the alien non-resident wife of taxpayer Harry S. Stonehill. Mr. and Mrs. Stonehill were married in 1951 and lived in the Republic of the Philippines until 1962. (Stip. 6/13/74, CR 670).

Petitioner Pacita C. Brooks was at all times relevant herein the alien non-resident wife of Taxpayer Robert P. Brooks. Mr. and Mrs. Brooks were married in 1956 and lived in the Republic of the Philippines until 1962. (Stip. 6/13/74, CR 670).

Both taxpayers Harry S. Stonehill and Robert P. Brooks were U.S. citizens who maintained their residences and principal businesses in the Philippines beginning prior to 1950; their principal source of income was derived from Philippine corporations commencing before 1950 and continuing to and including the date of their departure in 1962. *United States* v. *Stonehill, supra*, 702 F.2d 1288, 1297 (9th Cir. 1983).

The Senior Internal Revenue Service agent in this case wrote: "In the Summer of 1960, pursuant to communications from the U.S. Attorney, Honolulu, and Crime and Racketeering Section, Department of Justice, you [Office of International Operations of the Internal Revenue Service] made formal assignment of his [Stonehill's] return for the year 1958," (Ex. AAA, C-2). On February 21, 1961, the U.S. Attorney, Honolulu, subpoenaed Mr. Stonehill in Honolulu to testify before a Grand Jury. The testimony adduced related chiefly to Mr. Stonehill and at the trial on the merits of this case this Grand Jury testimony was admitted as the Government's General Exhibit 3, over objection (May 27, 1975 P.M. Session RT 59-60). On January 10, 1962 an official report was made to the Office of International Operations of the Internal Revenue Service in Washington wherein their representative in Manila transmitted the Embassy's view that ". . . it is imperative for American interests in the Philippines that some way be found to get Stonehill out of the Philippines and break his stranglehold here." (Ex.

AAA, C-2). The report goes on to give the view of the State Department that "the only attack that can be made on Stonehill is through I.R.S." (Ex. AAA, C-2). Shortly thereafter, in March 1962, the Philippine authorities raided the places of business in which Mssrs. Stonehill and Brooks had an interest and seized 35 truckloads of records which have never been returned to the taxpayers. Although the United States authorities have denied that they instigated these raids, they did admit their cooperation, *Stonehill* v. *United States*, 405 F.2d 738 (9th Cir. 1968), *cert den.* 395 U.S. 630 (1969).

On January 18, 1965, jeopardy tax assessments were filed against taxpayers Mssrs. Stonehill and Brooks, respectively, for the tax years 1958 through 1961. On January 25, 1965, the Government filed complaints against the taxpayers for foreclosure of liens. On February 24, 1975, at a hearing before the District Court (CR 1041, February 24, 1975), the Government conceded that the income of the taxpayers, which was the subject matter of this case, was community property income subject to the community property laws of the Republic of the Philippines. It was further conceded that the wives' (petitioners) share of all community income was vested at the time it was earned. The District Court stated at the evidentiary trial:

> "So, even though the Government may have the opportunity of levying upon the property of Stonehill and Brooks, claiming the full amount, the Government recognizes at least in the community property

hearing that less than one half of the amount claimed was actually due." (CR 1042, May 29, 1975 P.M. Session, RT 277).

Despite its concessions, the Government continued to argue to the District Court that the tax liens against the husbands could attach to and be foreclosed against vested community property of the petitioners-wives.

On July 23, 1976, the District Court rendered its Opinion, which constituted Findings of Fact and Conclusions of Law under Fed. R. Civ. P., Rule 52(a). The trial court found multimillion dollar tax deficiencies against the United States taxpayer-husbands. The trial court disposed of the issue raised by the alien non-resident wives, these petitioners, with the following language, *United States* v. *Stonehill, supra*, 420 F.Supp. 46, 64:

". . . the taxpayers' business enterprises during the tax years increased the conjugal property, and the wives shared in that increase. The taxpayers' U.S. income taxes are obligations incurred in connection with the acquisition of the additional conjugal property, and their [U.S.] tax liabilities may be satisfied from the wives' share of that property."

On appeal, the United States Court of Appeals for the Ninth Circuit recognized that the income from the taxpayers' business constituted income subject to The Philippines law of community property, as well as the corollary propositions that the taxpayers are taxable only on their half of such income, and that the wives cannot be taxed on their half. *United States* v. *Stonehill, supra* 702 F.2d at 1297.

Despite these findings, the Ninth Circuit upheld the District Court with respect to liens on what it perceived as two grounds: first, *ibid* at 1298:

> "The income and the tax were not two unrelated transactions; rather, they are aspects of a single transaction. The wives can no more retain the benefit of earnings while avoiding the non-beneficial taxes than they could retain a loan while avoiding the non-beneficial obligation of a promissory note."

and, second, *ibid* at 1299:

> "Article 161 [Philippine *Code*] gives certain of the husband's creditors rights against the conjugal property. Under the holding of *Babb* v. *Schmidt*, this is a sufficient property interest to support the tax liens."
>
> *Babb* v. *Schmidt*, 496 F.2d 957 (9th Cir. 1974)

(hereinafter referred to as "Babb"), cited by the appellate court, is a *California* case. The court below offered *no* direct Philippine authority for the proposition adduced by the Ninth Circuit in the *Babb* case. *United States* v. *Stonehill*, *supra*, 702 F.2d at 1299. The then-effective Section of the California Code provided: "The property of the community is liable for the contracts of either spouse which are made after marriage and prior to, or on or after January 1, 1975" (*Cal. Civ. Code*, Sec. 5116). Article 161 of the Philippine Code subjects the wives' share of community property to debts contracted by the husband for the benefit of the community.

Petitioners petition this Court for review of this decision, which in effect taxes indirectly what the Fed-

eral Government cannot tax directly, attempts to justify extra-territorial taxation, and applies United States law instead of Philippine law in searching for some justification of these unconstitutional procedures.

For a more comprehensive statement of the case giving the entire factual background, the court is respectfully referred to the 'statement of the case' in the separate petitions of Harry S. Stonehill or Robert P. Brooks.

BASIS FOR FEDERAL JURISDICTION OF COURTS BELOW

Jurisdiction in the respective United States District Courts rested on the provisions of 28 U.S.C. §§ 1340, 1345, and 26 U.S.C. §§ 7401-7403, I.R.C. 1954.

Jurisdiction of the United States Court of Appeals for the Ninth Circuit rested upon 28 U.S.C. § 1291.

REASONS FOR GRANTING THE WRIT

Federal tax authorities should not be permitted to tax indirectly what the Government cannot, as a Constitutional matter, tax directly, in violation of the sovereignty of another nation and the rights of its citizens.

The Ninth Circuit adopted the following initial premise, *United States of America* v. *Harry S. Stonehill, et al, supra*, 702 F.2d at 1297:

> "The Government concedes that it cannot tax the wives on their half of the conjugal income. The question here is whether tax liens arising from properly assessed deficiencies on the husband's half of the

income can be foreclosed against all of the conjugal property."

The intermediate appellate court then holds that the wives' income and the husbands' tax represent a single transaction, and further, that the alien non-resident wives cannot avoid these "non-beneficial taxes" on their income since they received their income from their United States citizen-husbands. The government and the lower courts conceded that the income taxed, and the only income which could be taxed, is the income of the husbands' half of the total income. The income of the petitioners-wives arising from their husbands' business activities in Manila cannot be taxed by the United States. How, then, could the income of the wives and the tax on the income of the husbands represent a single transaction?

The Ninth Circuit supports its theory with the example of a loan evidenced by a promissory note. *Ibid* at 1298. This is a *non-sequitur*. The Court determined that the petitioner-wives would not be permitted to "avoid the husbands' non-beneficial taxes", *ibid.*, not that a loan of the husbands' must be paid by the wives.

The holding within results in unconstitutional (Fifth Amendment) extra-territorial taxation of these petitioners. Federal tax obligations of the husbands here arose (if at all) by legislative enactment. These obligations were imposed by reason of public policy for the support of the United States. They bear no resemblance to voluntary-created contractual debts, not

even for the husbands, let alone for their foreign wives. While these taxes can be levied against the United States citizen-husbands and their income, any attempt to impose these taxes on the foreign wives (petitioners) or *their* income becomes "extra-territorial taxation", a term usually defined as follows:

> "Extra-territorial taxation is the imposition of a tax on income not within the jurisdiction of the country making the levy". Merten's *Law of Federal Taxation*, Sec. 45.02.

One constitutional method to lay claim based on the husbands' federal tax liens against the property of foreign wives arises where expressly provided by the sovereign state of citizenship of the wives. In other words, the Republic of The Philippines, by law, could specifically provide that a U.S. tax debt of U.S. husbands of Filipino wives could be collected against the wives' property. Not only is this situation not present here, it is inherently beyond the realm of probability. As the Ninth Circuit pointed out in another recent case, one sovereign nation normally will not even take notice of, let alone enforce, the revenue rules of another. *Her Majesty, the Queen In Right, etc.* v. *Gilbertson*, 597 F.2d 1161 (9th Cir. 1979) reh den (1979). See also, *United States* v. *Esperanza Harden*, 63-2 U.S.-T.C. 9768 (1963); *Moore* v. *Mitchell*, 30 F.2d 600 (2nd Cir. 1929); *aff'd* 281 U.S. 18, 50 S.Ct. 175; 74 L.Ed. 673 (1930).

The Court of Appeals cited numerous United States cases in commenting upon this vital issue raised by

petitioners. *United States* v. *Stonehill, supra*, 702 F.2d at 1298-1299. The context of these citations indicates that the appellate court was straining to treat these alien non-resident wives as if they were United States citizens-wives residing in the State of California! A relevant comment appears in the case of *Fink* v. *United States*, 454 F.2d 1387, 1393-1394 (1st Cir. 1972):

> "Plaintiffs further contend that Article I, Section 8 of the Constitution requires that persons from the same state be treated alike, such as two husbands, one married to a nonresident alien and the other to a United States citizen. This contention is easily answered. Such husbands are, in fact, treated alike. The husband married to a nonresident alien would be taxable on his share of the United States salary just like Edward. The wives are admittedly treated differently, since the nonresident alien wife is exempt from taxation on her share of the salary, whereas Joan, a citizen, is taxed. However, there is no constitutional requirement that a citizen be treated in a manner identical to a nonresident alien. A nonresident alien owes no allegiance to the United States or its Constitution and does not receive the same rights, privileges, and protection accorded to citizens by our laws."

The Court of Appeals goes further and maintains that the law of the Republic of the Philippines does provide creditors' rights against the property of the foreign wives for the unpaid U.S. taxes levied by the United States solely against the husbands' share of the community income. *United States* v. *Stonehill, supra*, 702 F.2d at 1298-1299. It is true that the Philippine

Code provides as the Court of Appeals has quoted, for liability for ". . . All debts and obligations contracted by the husband for the benefit of the conjugal partnership . . ." Civil Code of the Philippines, Republic Act 386 as amended, Art 161(1). However, the Court of Appeals then refers to the leading Philippine Supreme Court case of *Luzon Surety Co.* v. *DeGarcia*, 30 S.C.-R.A. 111, 115 (Phil. 1969) to support its position that The Philippines, as a sovereign state, recognizes that U.S. taxes levied on a U.S. husband's share of Philippine community income also constitute a liability of the Filipino wife's share of that income. *United States* v. *Stonehill*, *supra*, 702 F.2d at 1298. Neither the Philippine statute nor the Philippine Supreme Court so provides! *Luzon Surety Co.* v. *DeGarcia*, *supra*, clearly and specifically refers to contracted or business debts of the community, and even restricts such business debts with the language that, with regard to the claims of any purported creditor of the husband, "there must be the requisite showing then of some advantage which clearly accrued to the welfare of the spouse." [1]

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[1] The Opinion in this case in relevant part states:

". . . In the decision before us, the principal error assigned is the above holding of the Court of Appeals that under Article 161 of the Civil Code no liability was incurred by the conjugal partnership. While fully conscious of the express language of Article 161 of the Civil Code, petitioner, in its well-written brief submitted by its counsel, would impress on us that in this case it could not be said that no benefit was received by the conjugal partnership. It sought to lend some semblance of plausibility to this view thus:

(Footnote continued)

Neither the statute nor the Philippine Supreme Court even tangentially reach the view that the taxes of another sovereign country levied against citizens of

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(Footnote continued)

'The present case involves a contract of surety ship entered into by the husband, the respondent Vicente Garcia, by acting as guarantor and making good his guaranty, acquires the capacity of being trusted, adds to his reputation or esteem, enhances his standing as a citizen in the community in which he lives, and earns the confidence of the business comunity. He can thus secure money with which to carry on the purposes of their conjugal partnership.'

"While not entirely without basis, such an argument does not carry conviction. Its acceptance would negate the plain meaning of what is expressly provided for in Article 161. In the most categorical language, a conjugal partnership under that provision is liable only for such 'debts and obligations contracted by the husband for the benefit of the conjugal partnership.' There must be the requisite showing then of some advantage which clearly accrued to the welfare of the spouses. There is none in this case. Nor could there be, considering that the benefit was clearly intended for a third party, one Ladislno Chavez. While the husband by thus signing the indemnity agreement may be said to have added to his reputation or esteem and to have earned the confidence of the business community, such benefit, even if hypothetically accepted, is too remote and fanciful to come within the express terms of the provision.

"Its language is clear; it does not admit of doubt. No process of interpretation or construction need be resorted to. It peremptorily calls for application. Where a requirement is made in explicit and unambiguous terms, no discretion is left to the judiciary. It must see to it that its mandate is obeyed. So it is in this case. That is how the Court of Appeals acted, and what it did cannot be impugned for being contrary to law." *Luzon Surety Co., Inc.* v. *De-Garcia, supra,* at pp. 115-116.

that country, the United States in this case, can form the basis of a lien against the non-resident alien Filipino wives' property under Philippine law.

No Philippine case supports the position of the Court of Appeals that the husbands' tax lien in this case can attach to the wives' vested community property. Instead, the intermediate appellate court offers a number of domestic cases, e.g. *United States* v. *Stonehill, supra*, 702 F.2d at 1298-1299, and the Court ultimately relies on the California decision of *Babb* v. *Schmidt, supra*. The Ninth Circuit remarks, *ibid* at 1299:

> "We faced this issue squarely in *Babb* v. *Schmidt*, 496 F.2d 957 (9th Cir., 1974). There, California law made the community property liable for the husband's separate debts. The government tried to foreclose premarital income tax liens against all of the community property. Relying upon *Overman* and *Ackerman*, the wife argued that her husband had no property right in her half of the community property to which a tax lien could attach. We rejected her contention: 'If California law makes the wife's share of the community property available to creditors of the husband, California law has by the same implicity given the husband rights in that property sufficient to meet the requirements of 26 U.S.C. § 6321.'" *Id.* at 960.
>
> "The present situation is indistinguishable. Article 161 gives certain of the husband's creditors rights against the conjugal property. Under the hold-

ing of *Babb* v. *Schmidt*, this is a sufficient property interest to support the tax liens."

Petitioners are puzzled by the fact that the Court of Appeals quoted verbatim Article 161 of the Philippine Code yet failed to quote and compare the *California* statute upon which it places such reliance by virtue of *Babb* v. *Schmidt*, *supra*. That California statute is quoted neither in the opinion below nor in *Babb* v. *Schmidt*, *supra*, itself! Actually, the California statute[2] requires that all contracts of either spouse made after marriage shall become the responsibility of the entire community. There is no question under that statute of benefit or welfare of alien nonresident partners. Other Ninth Circuit appellate panels have ruled contrary to *Babb* v. *Schmidt*, *supra*, under similar circumstances: See e.g. *United States* v. *Overman*, 424 F.2d 1142 (9th Cir. 1970); *In Re Ackerman*, 424 F.2d 1148 (9th Cir. 1970); and *Commissioner of Internal Revenue* v. *Cadwallader*, 127 F.2d 547 (9th Cir. 1942). The Ninth Circuit also cites *U.S.* v. *Benitez Rexach*, 411 F.Supp. 1288 (D.P.R. 1976). *United States* v. *Stonehill*, *supra*, 702 F.2d at 1299. In this case, the Court held that the United States could foreclose on tax liens against the wife where the liens arose in connection with taxes on her share of community income during the period through November 9, 1949, when she was a citizen of the United States; the alien non-resident petitioners in the case at bar do not owe fealty or tax to the United States government.

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[2] Sec. 5116 of the California *Civil Code* is quoted in relevant part at page 9 of this petition, *supra*.

CONCLUSION

Petitioners pray that this Court issue a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, and hear this case on the merits, in order to prevent the employment of Federal liens to indirectly tax the persons and properties of alien non-residents where such a tax cannot be constitutionally levied by the United States pursuant to the Fifth Amendment.

Respectfully submitted,

TRAMMELL, RAND, NATHAN & LINCOLN, P.C.
BERT B. RAND
HANS A. NATHAN

By: .....
BERT B. RAND
Counsel of Record for Petitioners

APPENDIX A

UNITED STATES of America
Plaintiff-Appellee,

v.

Harry S. STONEHILL, Individually and as Trustee of the Lourdes Blanco Stonehill Children's Trust, The Elizabeth Anne Stonehill Trust, and The Susan J. Stonehill Trust, et al.,
Defendants-Appellants,

Trammell, Rand, Nathan & Lincoln, a Partnership, and Pacita Carrion Brooks,
Intervenors-Appellants.

Nos. CA 80-4590, 80-4598, 80-4599 and 80-6062

United States Court of Appeals, Ninth Circuit.

Argued and Submitted Oct. 22, 1982.
Decided April 8, 1983.
702 F.2d 1288
[headnotes deleted]

Before CANBY, NORRIS and REINHARDT, Circuit Judges.

CANBY, Circuit Judge:

The government initiated this action to foreclose income tax liens. After trial to the court, the district judge granted judgment in favor of the government. *United States* v. *Stonehill*, 420 F.Supp. 46 (C.D.Cal. 1976). The taxpayers, their wives, their lawyers and certain other parties appeal.

FACTS

Appellants Harry S. Stonehill and Robert P. Brooks (the taxpayers) are United States citizens who entered business in the Philippines after World War II. They settled in the Philippines and both married Filipino women. They prospered, eventually controlling many successful corporations and wielding great influence in Philippine politics.

In 1950, the taxpayers branched out into the cigarette manufacturing business by establishing the United States Tobacco Company (USTC). Their fortunes brightened considerably after 1958 when one of their companies obtained the first and only exclusive license (barter permit) to import American tobacco into the Philippines. For the license, the taxpayers made payments totalling ten million pesos (three million dollars at the black market exchange rate) to the ultimately victorious Philippine presidential candidate. The license gave the taxpayers a monopoly on Philippine sales of American tobacco, which consumers greatly preferred. USTC, controlled and largely owned by the taxpayers, was the principal beneficiary of the license. USTC bought the American tobacco and manufactured cigarettes for sale in the Philippines.[1] In the first fourteen months after the acquisition of the license, USTC's share in the Philippine cigarette market increased by some 1500% (from a 3.7% share to 58%).

1. The imported tobacco was used in cigarettes sold under the brand names Kent and Old Gold.

The district court found that, between 1958 and 1961, millions of dollars from various Philippine business dealings passed through the taxpayers' hands. Much of this money came from illegal and unrecorded sources.[2] The taxpayers extracted commissions and rebates from exporters and shippers of the American tobacco. They received kickbacks from Philippine manufacturers who were permited to buy imported tobacco, and they siphoned off large sums from USTC and other controlled corporations. Neither the corporate books nor the taxpayers' individual records reflected these transactions. Over nine million dollars flowed through black market channels to secret Swiss bank accounts and "shell" companies. Some of this money paid expenses of USTC in the United States.[3] About four million of these dollars were invested in American real estate and securities. During these years the tax-

2. These illegal dealings were documented by evidence introduced on the issue of fraud. The district court held that the government had proved fraud by clear and convincing evidence. The taxpayers do not contest this portion of the decision.

3. The tobacco barter permit allowed the taxpayers to import ten million pounds of American tobacco on condition that they export fourteen million pounds of Philippine tobacco. Supposedly, the value of the exported tobacco would equal the value imported, and thus prevent any flow of currency out of the Philippines. In fact, American tobacco cost about four times as much as Philippine. The taxpayers therefore needed large sums of money in the U.S. to purchase the American tobacco. Philippine law, however, severely restricted the outflow of currency from the country. Part of the diversion of funds to Switzerland was to evade these Philippine currency restrictions.

payers reported combined incomes of less than $200,000.

In about 1960, both American and Philippine officials became interested in the taxpayers' activities. The United States State Department believed that Stonehill was a corrupt influence on the Philippine government and wanted to get him out of that country.[4] Consequently, the United States Internal Revenue Service began to investigate the taxpayers' affairs.

On March 3, 1962, some 200 agents of the Philippine National Bureau of Investigation raided the offices of the taxpayers and seventeen of their corporations. The agents illegally seized thirty-five truckloads

4. A State Department interoffice memorandum dated January 10, 1962 stated:

> Parsons stated in the opinion of the Embassy it is imperative for American interests in the Philippines that some way be found to get Stonehill out of the Philippines and break his stranglehold here. The reasons for their concern were known to me, although I did not concern my December memorandum with details on the areas not of direct interest to Internal Revenue, nor will I burden the memo with these details. In general, however, Stonehill has had an evil and corrupt influence on the Philippine government in the past and has now indicated that he will manipulate the new administration in the Philippines even more visciously (sic). Whereas the American government is vitally interested in developing and improving the democracy and economy of the Philippines, it appears that Stonehill's individual influence may be sufficient to undermine the entire American effort and perhaps destroy democracy here and the cost to the United States will be immeasurable and much beyond the hundreds of millions involved in the aid programs and loans.

The memorandum concluded that the "only attack that can be made on Stonehill is through IRS."

of documents. Representatives of the United States Internal Revenue Service were permitted to examine these documents, and over 35,000 were eventually copied by the Internal Revenue Service.[5] A three year, worldwide audit ensued. More than fifty revenue agents audited some twenty-five business entities in the United States, the Philippines, Hong Kong, Australia, Japan, Canada, France, England and Germany. Because the taxpayers' records did not accurately reflect income, the Commissioner used the audit information to estimate unreported income by calculating the increase in the taxpayers' net worth. The Commissioner computed tax deficiencies (including interest and penalties) of $13,613,721.51 against Stonehill and $11,182,966.73 against Brooks.

Fearing that the taxpayers, if given time, would try to remove their assets from this country, the Commissioner issued "jeopardy" assessments pursuant to 26 U.S.C. § 6861 against the taxpayers on January 18, 1965.[6] Section 6861 permits the Commissioner to issue

5. The taxpayers' records were never returned to them by the Philippine government. Many of the records were apparently destroyed by a typhoon in 1970.

6. 26 U.S.C. § 6861(a) provides:

(a) Authority for making. —If the Secretary or his delegate believes that the assessment or collection of a deficiency, as defined in section 6211, will be jeopardized by delay, he shall, notwithstanding the provisions of section 6213(a), immediately assess such deficiency (together with all interest, additional amounts, and additions to the tax provided for by law), and notice and demand shall be made by the Secretary or his delegate for the payment thereof.

an assessment without first sending the usual notice of deficiency (90 day letter) when collection would be "jeopardized by delay." The filing of the jeopardy assessments created tax liens on the property of the taxpayers. 26 U.S.C. § 6321.[7] One week later, the United States commenced these actions to foreclose tax liens on certain of the taxpayers' properties in the United States.[8]

Years of litigation ensued, involving hundreds of depositions all over the world, dozens of hearings, and three successive judges. Resolution was complicated by the absence of crucial documents and witnesses (including the taxpayers themselves), by sensitive diplomatic and political considerations, and by many charges of misconduct made by both sides. In 1967, the taxpayers made a motion to suppress the evidence illegally seized in the Philippine raids. The district court concluded that the United States had not instigated or participated in the illegal searches and denied the motion. 274 F.Supp. 420 (S.D.Cal. 1967). We affirmed. 405 F.2d 738 (1968), *cert. denied*, 395 U.S. 960, 89 S.Ct. 2102, 23 L.Ed.2d 747 (1969).

After pre-trial hearings in 1974, the government

7. 26 U.S.C. § 6321 is quoted at note 12, *infra*.

8. The government filed suits to foreclose tax liens in the district courts for the Northern District of California, the Central District of California, and the District of Hawaii. The parties have agreed that the judgment of the District Court for the Central District of California shall be entered as the judgments in the other actions.

conceded that half of the taxpayers' income constituted income to their wives under Philippine community property laws. The wives are not subject to United States income taxation. Therefore, the amount of tax assessed against the taxpayers was halved.

Ten years after the action commenced, on May 27-30, 1975, it was tried before Judge Solomon. The government introduced many documents and depositions to prove fraud. To support the asserted tax deficiencies, however, the government introduced only the jeopardy assessments. The government thus chose to rely on the presumption that the assessments are correct, rather than proving each item of the underlying net worth computations. The jeopardy assessments themselves contained only bare assertions of tax due plus interest and penalties in each of the four years. Apparently by oversight, the net worth computations were never put into evidence at all.

The district court upheld the validity of the tax liens. The court adjusted the assessments to correct the treatment of the ten million peso bribe, and to reflect the conceded community property split. Although these adjustments greatly reduced the assessments, the district court held that the taxpayers had not rebutted the presumption of correctness. The district judge also rejected the wives' claim that the tax liens did not encumber their community half interest in the properties. *United States v. Stonehill*, 420 F.Supp. 46 (C.D.Cal. 1976).

After the main trial, Trammell, Rand, Nathan and Lincoln (TRNL), the lawyers representing the taxpayers, intervened to foreclose liens securing legal fees against some of the properties subject to litigation. The district judge rejected their claim, ruling that the TRNL's rights were ineffective against or inferior to the government's tax liens.

Four groups of defendants appeal:

(1) The taxpayers, Harry S. Stonehill and Robert P. Brooks, appeal the finding of tax liability.

(2) Their wives, Lourdes Blanco Stonehill and Pacita C. Brooks, appeal the decision that the liens encumber their community property interest in the properties.

(3) Trammell, Rand, Nathan and Lincoln, the law firm that defended the taxpayers, appeals the district court's ruling that any liens for attorneys' fees that they have upon these properties are invalid against the government.

(4) Finally, certain third parties appeal the judgment on the ground that it extinguished their interests in the property without their having an opportunity to litigate the issue.

I. *Tax Liability*

In the trial to foreclose tax liens, the government produced no evidence on the amount of tax liability, but chose instead to rely upon the presumption of cor-

rectness which applied to the assessments of tax. The taxpayers contend that the district court erred in awarding judgment on the basis of the presumption. They argue that the presumption never arose, or was destroyed by the substantial errors in the original assessments.

A. *Factual Foundation for the Assessments*

[1, 2] In an action to collect tax, the government bears the burden of proof. The government can usually carry its initial burden, however, merely by introducing its assessment of tax due. Normally, a presumption of correctness attaches to the assessment, and its introduction establishes a prima facie case. *Welch* v. *Helvering*, 290 U.S. 111, 115, 54 S.Ct. 8, 9, 78 L.Ed. 212 (1933); *United States* v. *Molitor*, 337 F.2d 917, 922 (9th Cir. 1964). The presumption does not arise unless it is supported by a minimal evidentiary foundation. *Weimerskirch* v. *Commissioner*, 596 F.2d 358, 360 (9th Cir. 1979). The taxpayers contend that the assessments here were not entitled to the presumption of correctness because they lacked any factual foundation.

[3, 4] The factual foundation for the assessment is laid "once some substantive evidence is introduced demonstrating that the taxpayer received unreported income." *Edwards* v. *Commissioner*, 680 F.2d 1268, 1270 (9th Cir. 1982) (per curiam). *Accord Weimerskirch* v. *Commissioner*, 596 F.2d 358, 360 (9th Cir.

1979); *United States* v. *Janis*, 428 U.S. 433, 441-42, 96 S.Ct. 3021, 3025-26, 49 L.Ed.2d 1046 (1976); *Suarez* v. *United States*, 582 F.2d 1007, 1010 n. 3 (5th Cir. 1978); *Carson* v. *United States*, 560 F.2d 693, 696-98 (5th Cir. 1977); *Gerardo* v. *Commissioner*, 552 F.2d 549, 552 (3d Cir. 1977). In *Weimerskirch*, the government assessed deficiencies based on allegedly unreported income from the sale of heroin. The government offered no evidence, however, showing that Weimerskirch had ever sold any heroin, or that he had received any unreported income. 596 F.2d at 361-62. This court held that the Commissioner was not entitled to rely solely on the presumption of correctness. Here, in contrast, overwhelming evidence demonstrated that the taxpayers had received millions of dollars of unreported income from their Philippine and American businesses. Between 1959 and 1962, more than nine million dollars flowed into secret Swiss bank accounts belonging to the taxpayers. The taxpayers acquired over four million dollars worth of property and securities in the United States with money from these Swiss accounts. During these years, the taxpayers reported income totalling only $200,000. The assessments thus stood securely upon a foundation of concrete evidence; the presumption of correctness was applicable.

The taxpayers next argue that this foundation evidence was admitted solely on the issue of fraud and cannot be used to support the presumption. This argument too narrowly restricts the ruling of the trial judge. He explained the permissible use of the evi-

dence: "The Government may rely on any evidence to defend the integrity of the Commissioner's determination against the taxpayers' attacks. The Government may not, however, rely on evidence admitted on the issue of fraud to prove specific items of tax liability." 420 F.Supp. at 57 n. 10. The district judge was concerned that the government might abandon its reliance upon the presumption of correctness by trying to prove and total up many individual items of tax liability. The government is not doing that here. To "defend the integrity" of the assessments comprehends supplying the necessary factual basis to show that they are not utterly without foundation. The use of the fraud evidence by the district judge himself reinforces this interpretation. The district judge used the fraud evidence in deciding that the taxpayers' records were inadequate, *id.* at 55 n. 9, and in showing a likely source of of income to justify the use of the net worth method, *id.* We are satisfied that the district court's admission of the fraud evidence was not so restricted as appellants contend, and that it is available to supply the *Weimerskirch* factual foundation.

We conclude the district court properly held that the presumption of correctness applied to the assessments.

B. *Taxpayers' Rebuttal of the Presumption*

The taxpayers contend that they successfully rebutted the presumption of correctness by demonstrating substantial errors in the assessments.

[5] Introduction of the presumptively correct assessment shifts the burden of proof to the taxpayer. *United States* v. *Molitor*, 337 F.2d 917, 922 (9th Cir. 1964). If the taxpayer rebuts the presumption, it disappears. In a suit to collect tax on unreported income, the burden of proving the deficiency then reverts to the government. *Herbert* v. *Commissioner*, 377 F.2d 65, 69 (9th Cir. 1967); 9 Mertens, Law of Federal Income Taxation § 49.218 (1976).

[6-8] To rebut the presumption of correctness, the taxpayer has the burden of proving that the assessment is "arbitrary or erroneous." *Helvering* v. *Taylor*, 293 U.S. 507, 515, 55 S.Ct. 287, 291, 79 L.Ed. 623 (1935); *Cohen* v. *Commissioner*, 266 F.2d 5, 11 (9th Cir. 1959). Where an assessment is based on more than one item, the presumption of correctness attaches to each item. Proof that an item is in error destroys the presumption for that single item; the remaining items retain their presumption of correctness. *Clark* v. *Commissioner*, 266 F.2d 698, 707 (9th Cir. 1959); *Hoffman* v. *Commissioner*, 298 F.2d 784, 788 (3d Cir. 1962); *Foster* v. *Commissioner*, 391 F.2d 727, 735 (4th Cir. 1968); *Anderson* v. *Commissioner*, 250 F.2d 242, 246 (5th Cir. 1957); *Banks* v. *Commissioner*, 322 F.2d 530, 538 (8th Cir. 1968). Even where the assessment has separable items, however, error which demonstrates a pattern of arbitrariness or carelessness will destroy the presumption for the entire assessment. *Hoffman* v. *Commissioner*, 298 F.2d 784, 788 (3rd Cir. 1962). *See Gasper* v. *Commissioner*, 225 F.2d 284 (9th Cir.

1955); *Cohen* v. *Commissioner*, 266 F.2d 5 (9th Cir. 1959); *Thomas* v. *Commissioner*, 223 F.2d 83 (9th Cir. 1955).

[9] Here, two "errors" reduced the assessments by about sixty percent: the pretrial concession that half of the conjugal income was not taxable to the taxpayers, and the trial court's decision that the ten million peso bribe should be treated as a business expenditure.[9] The district court held that the presumption of correctness applied to the remaining parts of the assessment, and that the errors did not show arbitrariness. These factual determinations of the district court will not be overturned unless they are "clearly erroneous." *Weimerskirch* v. *Commissioner*, 596 F.2d 358, 359-60 (9th Cir. 1979).

The taxpayers contend that the "multiple items" doctrine could not apply here, for these assessments contained no separable items but only solitary assertions of tax due in each year. Thus, they say, the errors left no "unaffected parts" to which the presumption could adhere. This argument fails, however, for the parts need not be delineated in the assessment itself. In *Clark* v. *Commissioner*, 266 F.2d 698 (9th Cir. 1959),

9. One other adjustment was made to the assessments. About $700,000 in bribes to various officials were documented in a secret "Blue Book." The State Department feared that publication of the Blue Book would damage United States foreign policy interests. The government therefore agreed to treat the $700,000 as deductible business expenses and the taxpayers agreed not to claim that this change in the assessments made them arbitrary. The district court then sealed the book.

we held that error in one separable item did not infect the entire assessment. The parts in that case were not separately set forth in the assessment itself, but in a report prepared by a government agent. *Id.* at 705 & 707. *Accord, Banks* v. *Commissioner*, 322 F.2d 530, 538 (8th Cir. 1968). Thus, in the present case, the multiple items could be supplied by the net worth calculations underlying the assessments. Reliance upon the net worth computations is complicated by the government's failure to put them into evidence. In this case, however, the taxpayers admit that they received the net worth calculations in their notices of deficiency. They actually attacked several individual items of the calculations, and showed that the Commissioner had erroneously excluded the ten million peso bribe from their opening net worth. Attorneys for both sides, on the record, made repeated references to the net worth calculations and the numerous items of which they were comprised.[10] In these circumstances, the district judge correctly ruled that the assessments were based upon multiple items, and that the presumption continued to apply after the adjustments.

The taxpayers have also failed to prove that the errors demonstrate a pattern of arbitrariness. *Gasper* v. *Commissioner*, 225 F.2d 284 (9th Cir. 1955), presents the kind of pervasive arbitrariness that can taint the entire assessment. There, the Commissioner used

10. The status of the net worth calculations was somewhat unclear. The district judge based portions of his opinion upon them. 420 F.Supp. at 59-61.

the "mark-up" method to determine income for a small pub. The Tax Court found, however, that the number of bottles consumed during the year was known, as were the various prices per drink and number of drinks per bottle. A simple calculation could accurately determine income, yet the Commissioner adopted a method which appeared to bear only a slight relationship to actual income. For one class of liquor the mark-up method overstated income by more than fifty percent. *Id.* at 285. Thus, the method chosen was unnecessarily crude. All of the resulting assessments were infected by this fundamental error; no presumption could survive.

Neither of the errors here shows the arbitrariness displayed in *Gasper*. Whether the taxpayers were taxable on all of their business income or (as ultimately proved to be the case) on only half presented a difficult question of Philippine law. Experts differed. The taxpayers themselves failed to make community property claims on their returns. In these circumstances, the government's pre-trial concession of this unclear legal point does not cast doubt upon the other items underlying the assessment, nor show carelessness. *See Gobins* v. *Commissioner*, 18 T.C. 1159, 1169 (1952), *aff'd per curiam*, 217 F.2d 952 (9th Cir. 1954); *Silverman* v. *Commissioner*, 538 F.2d 927, 930-31 (2d Cir. 1976). The district judge was correct in finding that this error did not destroy the presumption.

Similarly, the Commissioner's classification of the

ten million peso bribe as a personal expenditure, although error, was reasonable. The payment was illegal and was not reflected in the records of any of the taxpayers' corporations. The money apparently came from the taxpayers' personal funds. The mistaken treatment of this payment did not demonstrate a pattern of pervasive arbitrariness that could infect the entire assessment.

[10] These conclusions are buttressed by the nature of this case. The Commissioner was forced to use the imprecise net worth method of estimating income because the taxpayers' records were unreliable and did not accurately reflect income. 420 F.Supp. at 55. Some error is unavoidable in such a reconstruction. *Banks* v. *Commissioner*, 322 F.2d 530, 548 (8th Cir. 1963). Errors arising from the taxpayers' attempts to conceal their income will rarely rebut the overall presumption of correctness. Skillful concealment must not raise an insurmountable barrier to proof. *United States* v. *Johnson*, 319 U.S. 503, 518, 63 S.Ct. 1233, 1240, 87 L.Ed. 1546 (1943).

The district judge was correct in holding that the assessments, after adjustment to reflect necessary changes, continued to carry the presumption of correctness. Because the taxpayers failed to discharge their burden of rebutting the presumption, the tax liability was established.

C. *Other Contentions*

[11, 12] The taxpayers contend that the use of the

net worth method was improper. The net worth method is acceptable only if the taxpayers' records do not accurately reflect income. *Holland* v. *United States*, 348 U.S. 121, 125, 75 S.Ct. 127, 130, 99 L.Ed. 150 (1954). Here, taxpayers caused millions of unrecorded dollars to be deposited in Swiss bank accounts. Any contention that the taxpayer's records accurately reflected income is frivolous. Use of the net worth method here was proper.

[13, 14] The taxpayers next argue that the government may have abandoned the presumption of correctness by switching to a theory of constructive dividends. Such a change of legal theory may destroy the presumption that the assessments were correct. *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481, 57 S.Ct. 569, 81 L.Ed. 755 (1937). The government's constructive dividend theory, however, was not a change from the net worth method, but an integral part of it. Some of the money from the Swiss accounts was used to pay expenses of USTC in America. In calculating the taxpayers' closing net worth, the government treated these payments as capital contributions to USTC, and therefore as evidence of taxable income. The taxpayers attacked this allocation, arguing that the money represented USTC earnings in the Philippines used to pay USTC expenses in the United States. Thus, the taxpayers argued that these increases in net worth were not yet taxable to them. *See United States v. Smith*, 418 F.2d 589, 593 (5th Cir. 1969); *Ireland* v. *United States*, 621 F.2d 731 (5th Cir. 1980) (a constructive

dividend must advance the shareholder's personal, not business interest). The government replied that while in the Swiss accounts, the money was under the sole control of the taxpayers. The money thus amounted to constructive dividends to them from their corporations, and was income. *Corliss* v. *Bowers*, 281 U.S. 376, 378, 50 S.Ct. 336, 336, 74 L.Ed. 916 (1930); *Hartman* v. *United States*, 245 F.2d 349, 352-53 (8th Cir. 1957). So employed, the constructive dividend theory was merely an underlying part of the government's net worth case. Reliance on this sub-theory does not defeat the presumption.

The taxpayers also complain that, although they were ready to attack specific items of the net worth computations, they were unable to do so because the figures were never put into evidence. The absence of these calculations, they contend, made it unfairly difficult for them to carry their burden of proving the assessment arbitray or erroneous.

The taxpayers' protestations of unfairness, however, fly in the face of the record. The taxpayers admit that they received notices of deficiency which set forth the net worth calculations. The taxpayers deposed a government agent regarding the net worth statements and in 1972 received detailed requests for admissions concerning the net worth computations. Their own counsel repeatedly referred to the large number of items comprised in the calculations. Finally, the taxpayers actually attacked several individual elements of

the net worth calculations: the cash on hand in the opening net worth, the government's failure to include the ten million peso payment as an asset in their opening net worth, the original value of stock in USTC, and the inclusion in the closing net worth of payments from the Swiss accounts for the benefit of USTC in the United States. The district court agreed with their argument concerning the ten million peso payment. 420 F.Supp. at 59.

[15] Fairness may indeed require that the taxpayer know the basis for an assessment. We certainly do not recommend that the government refrain from putting its net worth computations into evidence. Nevertheless, the taxpayers here knew each detail of the calculations. Under these circumstances, no substantial unfairness resulted from the failure to introduce the computations into evidence.

[16] Finally, the taxpayers argue that the judgment assumes certain matters that are not supported by the record: for example, the amount of long-term capital gain, the amount of dividends received credit, and whether the ten million peso bribe was made with separate or community property funds. This argument is not well-founded. The asumptions of capital gains and dividends credit were used in making the assessment and so are presumptively correct. The taxpayers have not carried the burden of proving them wrong. The fifty-fifty split made by the district court in allocating the community property interest was reasonable in the

absence of other indications; the taxpayers have not shown it to be incorrect. The judgment thus rests securely on the prima facie case created by the assessments.

We therefore hold that the presumption of correctness applied to those assessments and was not rebutted. The judgment of tax liability is accordingly affirmed.

II. *Community Property Interests*

The realty covered by the government's tax liens is community property. The parties agree that the nature and extent of the husband's interests in the properties is governed by Philippine law. Taxpayers' wives contend that under Philippine law and the Internal Revenue Code the tax liens cannot apply to more than their husbands' half interests in the property. The district court rejected this argument and the wives appeal.

[17] Under Philippine law, income from the husbands' businesses was conjugal property[11] in which the wife had an immediate vested half interest. Philippine Civil Code Ann. Art. 153 (1971). The taxpayers are taxable only on their half of the community income. Rev.Rul. 269, 1956-1 C.B. 318; *United States v. Mitchell*, 403 U.S. 190, 197, 91 S.Ct. 1763, 1768, 29 L.Ed. 2d 406 (1971). The wives are neither citizens nor residents of the United States and so are not subject to United States income tax.

11. Philippine law uses the term "conjugal property" instead of community property. For our purposes, they have the same meaning.

[18] The government concedes that it cannot tax the wives on their half of the conjugal income. The issue here is whether tax liens arising from properly assessed deficiencies on the husbands' half of the income can be foreclosed against all of the conjugal property.

[19] Philippine law provides that the conjugal property is liable for certain debts of the husband. Article 161 of the Philippine Code provides: "The conjugal partnership shall be liable for (1) all debts and obligations contracted by the husband for the benefit of the conjugal partnership . . ." Generally, obligations incurred in the course of a trade or business are for the benefit of the community. *Luzon Surety Co.* v. *De-Garcia*, 30 S.C.R.A. 111, 115 (Phil. 1969). In certain unusual circumstances, where the community received no actual benefit, business obligations have been held to fall beyond the scope of Article 161. *Id.* (husband received no consideration for standing as surety on a debt); *Laperal v. Katigbak*, 104 Phil. 999, 1004-05 (1958) (spouses separated and wife no longer received any of the business income). Here, the wives undeniably received the benefits of their husbands' business income; the tax obligations were incurred to benefit the community.

The wives argue that, although they received income from their husbands' businesses, they received no benefit from the attachment of the tax liens. This argument ignores the reality of this transaction. The

income and tax were not two unrelated transactions; rather they are aspects of a single transaction. The wives can no more retain the benefit of earnings while avoiding the non-beneficial taxes than they could retain a loan while avoiding the non-beneficial obligation of a promissory note. *See Laperal* v. *Katigbak*, 104 Phil. at 1004; *Javier* v. *Osmena*, 34 Phil. 336 (1916).

Second, the wives contend that their husbands lack any property interest in the wives' half of the property to which the tax liens can attach.

[20] Pursuant to 26 U.S.C. § 6321 (1967), a lien for unpaid taxes arises upon "all property and rights to property, whether real or personal, belonging to such person."[12] Local law, here Philippine, determines whether the taxpayer has "rights to property" to which the tax lien may attach. *See Morgan* v. *Commissioner*, 309 U.S. 78, 80, 60 S.Ct. 424, 425, 84 L.Ed. 585 (1940); *Runkel* v. *United States*, 527 F.2d 914 (9th Cir. 1975). Because the tax deficiencies were assessed only against the husbands, the tax liens under Section 6321 can encumber only property in which the husbands have some right. The wives contend that their

12. 26 U.S.C. § 6321 provides:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

husbands have no property rights in the wives' half of the conjugal property, and that the tax liens therefore cannot extend to more than the husbands' half of the conjugal properties.

For support, the wives cite *United States* v. *Overman*, 424 F.2d 1142 (9th Cir. 1970); *Ackerman* v. *United States*, 424 F.2d 1148 (9th Cir. 1970), and *Commissioner* v. *Cadwallader*, 127 F.2d 547 (9th Cir. 1942). None of these cases, however, is controlling.

In both *Overman* and *Ackerman*, state law prevented a husband's premarital creditors from reaching any of the community property. The government nevertheless attempted to foreclose premarital tax liens against the community property. The wives argued that the husbands lacked a separate property interest in any of the community property to which a premarital tax lien could attach. *Overman*, 424 F.2d at 1145; *Ackerman*, 424 F.2d at 1149. We held that § 6321 overrode the state creditor exclusion and that the husband had a sufficient property right in his undivided one half interest in the community property for the assertion of tax liens. *Overman*, 424 F.2d at 1146; *Ackerman*, 424 F.2d at 1150.

Thus, *Overman* and *Ackerman* extended the reach of premarital tax liens to half of the community property even when state law insulated the community property from premarital creditors generally. In the present case, in contrast, Philippine law (Article 161) permits the liens to reach *all* of the conjugal property.

Nothing in *Overman* or *Ackerman* reduces the reach of the tax liens below what local law permits.

In *Commissioner* v. *Cadwallader*, 127 F.2d 547 (9th Cir. 1942), we considered the application of federal estate taxes to an American couple living in the Philippines. When the husband died, we held that "for the purpose of the federal estate tax the husband must be held to have no interest in the wife's share of the conjugal estate." *Id.* at 549-50. Thus, the assessment of estate tax was limited to his half of the community property. Similarly, here, income tax was assessed on only half of the community income. *Cadwallader* does not control on the issue of whether the husband has a property interest in the conjugal property for purposes of section 6321.

We faced this issue squarely in *Babb* v. *Schmidt*, 496 F.2d 957 (9th Cir. 1974). There, California law made the community property liable for the husband's separate debts. The government tried to foreclose premarital income tax liens against all of the community property. Relying upon *Overman* and *Ackerman*, the wife argued that her husband had no property right in her half of the community property to which a tax lien could attach. We rejected her contention: "If California law makes the wife's share of the community property available to creditors of the husband, California law has by the same rule implicitly given the husband rights in that property sufficient to meet the requirements of 26 U.S.C. § 6321." *Id.* at 960.

The present situation is indistinguishable. Article 161 gives certain of the husband's creditors rights against the conjugal property. Under the holding of *Babb* v. *Schmidt*, this is a sufficient property interest to support the tax liens. *Accord United States v. Rexach, F. V.*, 77-1 U.S.T.C. ¶ 9105 (D.P.R. 1977); *United States* v. *Benitz Rexach*, 411 F.Supp. 1288 (D.P.R. 1976) rev'd on other grounds, *United States* v. *Lucienne D'Hotelle*, 558 F.2d 37 (1st Cir. 1976) (the tax liens imposed on the community property, but tax liability so secured did not exceed half of community assets).

The district court was therefore correct in deciding that the tax liens encumbered all of the conjugal property.

III. *Liens for Attorney's Fees*

TRNL appeals the district court's ruling that any rights TRNL has in these properties are subordinate to the government's tax liens.

On January 25, 1965, the United States filed notices of tax liens and notices of pendency of action covering all of the property subject to this suit. Shortly thereafter, the taxpayers employed TRNL to defend them in the ensuing litigation.

On April 8, 1965, the taxpayers and the United States executed a stipulation regarding the property

subject to the tax liens. Paragraph four of the stipulation provides:

> (a) Upon the approval hereof by the Court this stipulation shall constitute an order of the Court effective forthwith and restraining defendant Harry S. Stonehill, his agents, employees and attorneys, from in any manner, either directly or indirectly, selling, mortgaging, pledging, encumbering, assigning, or otherwise disposing of, or withdrawing or removing all or part of the properties or assets which he owns in the United States, including, but not limited to those listed in the attached Schedule A, from the jurisdiction of this Court or from the jurisdiction of the United States District Court for the Northern District of California or from the jurisdiction of the United States District Court for the District of Hawaii (as the case may be) or from the territorial confines of the United States.

Attorneys from TRNL signed the stipulation on behalf of the taxpayers.[13]

By 1977, the taxpayers owed TRNL some $800,000

13. Hans Nathan, a partner in TRNL, later explained the stipulation:

> I personally negotiated and reached an understanding with opposing counsel to the effect that, to effect an orderly disposition of this case without causing any prejudice to the United States, the Defendant would be permitted to obtain funds from sources abroad; to expend these funds freely to defray his living expenses and for the expenses of this suit during the pendency thereof. Defendant in turn would not attempt to dispose of any assets located in the United States at the time of the entering into of said agreement. The agreement was implemented by a stipulation and order dated April 9, 1965 and filed herein.

in legal fees. To satisfy this obligation, the taxpayers executed trust deeds conveying security interests in certain California properties to TRNL. The law firm filed the deeds in the records of Marin County, California. The properties were already the subject of this litigation.

TRNL asserts that it has liens on these properties, either because of the trust deeds or because of equitable liens for attorney's fees arising under California law. TRNL also argues that its rights have priority over the government's tax liens.

[21] The government's properly filed tax liens normally would take priority over the subsequent rights of TRNL. 26 U.S.C. § 6321. To retain the original priority longer than six years, however, 26 U.S.C. § 6323(g) requires the government to refile its notice of tax lien. Here the government failed to refile within the statutory period. Although the failure to refile does not affect the validity of the liens, it may reduce their priority. S.Rep. No. 1708, 89th Cong., 2d Sess. (Sen.Fin. Comm.) *reprinted* in 1966 U.S. Code Cong & Admin. News 3722, 3733. Treasury Regulation 26 C.F.R. 301. 6323(g)-1, however, creates an exception to the refiling requirement for property "which is the subject matter of a suit to which the United States is a party, commenced prior to the expiration of the required refiling period." TRNL contends that the regulation is invalid because it is contrary to the legislative intent of the statute it purports to interpret. Because of our

resolution of TRNL's claims, we need not reach this issue.[14]

A. *The Deeds of Trust*

[22, 23] Generally, a client may by agreement grant his attorney a lien to secure legal fees. *Isrin* v. *Superior Court*, 63 Cal.2d 153, 403 P.2d 728, 45 Cal.Rptr. 320 (1965); *Norman* v. *Berney*, 235 Cal.App.2d 424, 45 Cal.Rptr. 467 (1965); *Wagner* v. *Sariotti*, 56 Cal.App. 2d 693, 133 P.2d 430 (1943). Here, however, the district judge ruled that the deeds of trust conveyed no valid security interest because they violated the court order. TRNL argues that this ruling was error. By affidavit, TRNL states that the stipulation was not intended to apply to attorney's fees, but was only to prohibit assignment to foreign entities.

TRNL's interpretation ignores the plain wording of the order. The order prohibits "in any manner, either directly or indirectly, selling, mortgaging, pledging, encumbering" the property subject to tax liens. This language is unambiguous. TRNL's own 1969 explication of the meaning of the order is in accord. *See* note 13 *supra*. The district court did not err in finding that the attempted conveyance violated the order.

14. The government argues that regardless of the validity of the treasury regulation the tax liens take priority under the California law of *lis pendens*. We note that the special filing procedures for tax liens may preclude reliance upon state *lis pendens* rules to protect tax liens. Again, however, in view of our disposition of TRNL's claims, we need not decide this issue.

Nor did the district judge err in holding that the deeds of trust could convey to TRNL no interest superior to the tax liens. TRNL was present at the negotiation and signing of the stipulation. The attempted conveyance treads dangerously close to wilful violation of a court order. A federal court's general equitable and disciplinary powers suffice to invalidate the deeds of trust under these circumstances. *See Lamb* v. *Cramer*, 285 U.S. 217, 52 S.Ct. 315, 76 L.Ed. 715 (1932). Any rights of TRNL arising by agreement with the taxpayers are junior to the government's tax liens.

[24] TRNL also asserts equitable liens for attorney's fees arising by operation of California law. California law provides an equitable lien for attorneys in only two situations: the creation of a "common fund" or the maintenance of litigation which produces "substantial benefits" for a class. *Mandel* v. *Hodges*, 54 Cal.App.3d 596, 620, 127 Cal.Rptr. 244, 260 (1976); *Fletcher* v. *A. J. Industries, Inc.*, 266 Cal. App.2d 313, 320, 72 Cal.Rptr. 146 (1968). TRNL contends that by substantially reducing the assessment it "protected and preserved" a fund, and thus falls within the "common fund" doctrine under the holding of *Winslow* v. *Harold G. Ferguson Corp.*, 25 Cal.2d 274, 153 P.2d 714 (1944).

In *Winslow*, a lawyer represented some beneficiaries of a trust. The trust purpose had become impossible to achieve and all the beneficiaries were in danger of losing the value of their interests. The lawyer

succeeded in terminating the trust and securing the appointment of a receiver to liquidate the trust assets and distribute them to the beneficiaries and creditors. 153 P.2d at 716. The California Supreme Court stated:

> It is a well-established doctrine of equity jurisprudence that where a common fund exists to which a number of persons are entitled and in their interest successful litigation is maintained for its preservation and protection, an allowance of counsel fees may properly be made from such fund. By this means all of the beneficiaries of the fund pay their share of the expense necessary to make it available to them.

Id. 153 P.2d at 715. In *Winslow*, the United States was one of the creditors. The court held that an equitable lien arose upon the trust assets for the attorney's fees and took precedence even over pre-existing tax liens. The court commented: "Counsel's right to compensation under such circumstances arises from the benefit conferred upon those who would have suffered loss but for his timely intervention, and not by reason of an agreement to pay his fees." *Id.* 153 P.2d at 719.

The situation at hand is very different from *Winslow*. In *Winslow*, the United States was one of a class of creditors who benefited from the lawyers' efforts in protecting the common fund from dissipation. Here, in contrast, no "common fund" existed. TRNL did not "preserve" a fund for the benefit of the United States. Its efforts, in fact, were directed toward defeating the government's claims. TRNL's reliance upon *Winslow*

thus is misplaced. No lien arises in these circumstances. For the same reason the following cases cited by TRNL are inapposite: *Kennebec Box* v. *O. S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925); *In re Holmes Manufacturing Co.*, 19 F.2d 239 (2d Cir. 1927); *In re Columbia Ribbon Co.*, 117 F.2d 999 (3d Cir. 1941); *Bauer & Son* v. *Wilkes-Barre Light Co.*, 274 Pa. 165, 117 A. 920 (1922), and *Malm* v. *Home Riverside Coal Mines Co.*, 152 Kan. 419, 103 P.2d 798 (1940).

Finally, TRNL argues that *Mackall* v. *Willoughby*, 167 U.S. 681, 17 S.Ct. 954, 42 L.Ed. 323 (1897), supports its claim to an equitable lien. *Mackall*, however, is not on point. In *Mackall*, the attorney and client had a *written fee* agreement. The dispute involved the proper construction of their word "recovered" as used in the contract. *Mackall* provides no benefit for a party asserting non-contractual liens.

Thus, California law provides no equitable lien in favor of TRNL. Because the trust deeds conveyed no interest, the district court correctly ruled that TRNL has no interest in any of the properties subject to the government's tax liens.

IV. *Other Appellants*

[25] Appellants Ben Gromet, William W. Saunders, Tower Development Corporation, and Meriwether Development Corporation claim interests in certain properties involved in this suit. These appellants stipulated that the validity of the tax liens should be tried before

determination of their respective rights in the property. The district court's order purported to dispose of the interests of all parties, although it did not expressly consider the claims of these appellants.

These appellants have not yet had their day in court. The judgment, insofar as it pertains to them, is reversed and remanded to the district court for determination of their claims.

CONCLUSION

The judgment insofar as it relates to Ben Gromet, William W. Saunders, Tower Development Corporation and Meriwether Development Corporation is reversed and remanded for resolution of their claims. The judgment as it relates to all other appellants is affirmed.

AFFIRMED in part; REVERSED in part and REMANDED.

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FILED
SEP 01 1983
PHILLIP B. WINBERRY
CLERK, U.S. COURT OF APPEALS

UNITED STATES OF AMERICA,	)	
	)	
Plaintiff-Appellee,	)	
	)	
HARRY S. STONEHILL, Individually	)	No. CA 80-4590
and as Trustee of the Lourdes	)	80-4598
Blanco Stonehill Children's Trust,	)	80-4599
The Elizabeth Anne Stonehill Trust,	)	80-6062
and The Susan J. Stonehill Trust, et al.,	)	D.C.
Defendants-Appellants,	)	
	)	
TRAMMEL, RAND, NATHAN &	)	No. 65-127-GJS
LINCOLN, a Partnership; AND	)	43244-SW
PACITA CARRION BROOKS,	)	2348
	)	ORDER
Intervenors-Appellants.	)	

BEFORE: CANBY, NORRIS and REINHARDT, Circuit Judges.

A majority of the panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for an en banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX C

UNITED STATES of America, *Plaintiff*,

v.

HARRY S. STONEHILL et al., *Defendants*.

Civ. No. 65-127-GJS

United States District Court,
C. D. California.

July 23, 1976.

420 F. Supp 46 (C. D. Cal. 1976)

[Headnotes deleted]

OPINION

SOLOMON, District Judge.

I. *Preliminary Statement*

This is an action to foreclose federal tax liens of about $25 million.

Defendants Harry S. Stonehill and Robert P. Brooks (the taxpayers) are United States citizens who settled in the Philippines after World War II. They became successful and powerful businessmen. They owned, were officers of, or controlled many business organizations and were active in Philippine politics.

About 1960, both Philippine and United States officials became interested in the taxpayers' activities. On March 3, 1962, about 200 agents of the Philippine

National Bureau of Investigation (the NBI) raided the offices of the taxpayers and the offices of 17 companies which they controlled. The NBI took about 35 truckloads of documents.

Agents of the United States Internal Revenue Service (the IRS) spent months examining these documents. On January 18, 1965, the Commissioner of the IRS assessed income tax deficiencies for the tax years 1958 through 1961 against defendant Stonehill of $13,613,721.51 and against defendant Brooks of $11,182,966.73.

On January 25, 1965, the United States filed this action to foreclose tax liens on certain property owned by the taxpayers in this district. Similar foreclosure actions were filed in the Northern District of California [1] and in the District of Hawaii [2]. In an order dated April 9, 1965, the United States and the taxpayers stipulated that, when all opportunities for appeal have been exhausted, the judgment of this Court shall be entered as the judgment in the other two cases.

Thirteen years after the Philippine raids, this case was finally tried on the merits. The parties engaged in extensive discovery; they followed leads and gathered evidence in the Philippines, the United States, Canada, Belgium, Luxembourg, Switzerland, Japan, and Hong Kong. The parties vigorously litigated the taxpayers' charges that the Government illegally seized

1. Civil Action No. 43244.
2. Civil Action No. 2348.

certain evidence. The taxpayers' motion to suppress was denied by the trial court, and in 1968 the Ninth Circuit Court of Appeals affirmed; the Supreme Court denied certiorari. The taxpayers renewed the motion to suppress several times.

Lawyers, accountants, and investigators for both the Government and the taxpayers have spent years working on this case, and the parties have spent many hundreds of thousands of dollars prosecuting and defending it. There have been more than 35 separate court sessions. In 1972, I became the third judge assigned to the case.

The decision of this case has been complicated by the complexity of the taxpayers' financial transactions and business entities, by the non-existence or unavailability of crucial records and documents, by the unavailability or noncooperation of important witnesses, including Stonehill and Brooks who refused to appear, and by sensitive political and diplomatic considerations.

These difficulties have been compounded by numerous allegations of misconduct asserted by the Government against the taxpayers and by the taxpayers against the Government at all levels. The Government alleges that the taxpayers made fortunes through illegal business activities, fraudulently concealed millions of dollars in income, bribed high Philippine officials, and sometimes resorted to gangland tactics to deal with their enemies.

The taxpayers allege that the Government, through the Justice Department, the State Department, the IRS, the Federal Bureau of Investigation (the FBI) and the Central Intelligence Agency (the CIA), conspired with Philippine officials to ruin them financially and to force them to leave the Philippines. The taxpayers further allege that the Government illegally seized and stole their records, spread false and malicious rumors about them, caused them to be arrested and deported from the Philippines and excluded from other foreign countries, planted a Government informer in their business, illegally tapped their telephones, and deliberately concealed evidence favorable to them.

II. *Motion to Suppress*

In March 1967, the taxpayers filed a motion to suppress. In October 1967, after a nine-day hearing on this motion, District Judge Westover denied it. 274 F.Supp. 420 (S.D.Cal.). His interlocutory order of denial was appealed under 28 U.S.C. § 1292(b). The Ninth Circuit Court of Appeals affirmed. 405 F.2d 738 (1968), *rehearing denied*, 405 F.2d 738 (1969), *cert. denied*, 395 U.S. 960, 89 S.Ct. 2102, 23 L.Ed.2d 747, *rehearing denied*, 396 U.S. 870, 90 S.Ct. 39, 24 L.Ed.2d 125.

The Court of Appeals held that, although the 1962 raids were illegal under both United States and Philippine law, the evidence seized in those raids was admissible because it was handed to United States officials on

a "silver platter". After setting forth the role that United States officials played in the raids, the Court concluded that the United States officials did not instigate or direct or significantly participate in the raids by Philippine officials. The case was remanded to the district court for trial on the merits.

In February 1971, the taxpayers filed a "Renewed Motion to Suppress Evidence" based on newly discovered evidence. On May 26, 1971, Judge Westover denied the renewed motion.

In August 1971, the taxpayers filed a "Motion for Reconsideration of Order Dated May 26, 1971". In November 1971, Judge Westover, after oral argument, denied the motion because the new evidence was "merely cumulative of evidence previously offered" and raised "no new significant evidence in support of . . . [the taxpayers'] position".

In May 1975, the taxpayers renewed their motion to suppress, which is now before the Court. They contend that new evidence discovered since the 1968 Court of Appeals' decision requires suppression of the evidence seized in the 1962 raids. In addition, the taxpayers seek to suppress evidence which they contend was "obtained by other illegal acts and methods" such as "wiretapping and theft of documents".

[1] The threshold question here is whether the taxpayers may renew their motion to suppress after the Court of Appeals affirmed the denial of their earlier motion. I hold that they may.

[2] The doctrine of res judicata does not apply to an interlocutory order, such as a motion to suppress, even if the order was affirmed on appeal. *Pennsylvania Turnpike Commission* v. *McGinnes*, 169 F.Supp. 580 (E.D.Pa.1958). The appellate decision does, however, become the "law of the case". As the Eighth Circuit said in *Toucey* v. *New York Life Insurance Co.*, 112 F.2d 927, 928 (1940):

> "A decision of an appellate court is, as to the legal issues considered and determined, the law of the case in any subsequent proceedings in either the trial or the appellate court, and is to be followed except where the evidence is substantially different, or where, between the date of the decision and the time of the reconsideration of the case, controlling authority has determined the legal issues adversely, or where it appears that the decision was clearly erroneous and that adherence to it will work a manifest injustice."

The Court of Appeals' opinion on the taxpayers' original motion to suppress adequately sets forth the evidence before that court. I shall not repeat that evidence here.

A. *Renewal of Motion to Suppress Raid Documents*

The taxpayers contend that since that decision they have discovered new evidence which proves that United States officials instigated and directed the 1962 raids.[3]

3. The taxpayers' newly discovered evidence does not relate to the physical participation by United States officials in the raids.

They therefore contend that the evidence seized in those raids should be suppressed.

[3] Because the 1968 Court of Appeals' decision is the law of this case, the taxpayers can prevail only if they show that the newly discovered evidence, when considered with the total record, materially changes the evidence in support of their position.

The taxpayers contend that their new evidence shows that United States officials were actively investigating the taxpayers much earlier than the previous evidence showed. They also contend that the Philippine authorities who conducted the raids were acting at the instigation and direction of United States officials.

Contrary to these contentions, I find that United States officials were interested in the taxpayers' activities before Menhart Spielman talked to FBI agent Hawley in December 1961, but that these officials did not conduct an active investigation. But even an active investigation before December 1961 does not prove that the United States officials had anything to do with the raids.

Furthermore, even if they did actively investigate the taxpayers before December 1961, that does not materially add to the evidence before Judge Westover in 1967. By January 1962, more than a month before the raids, the officials decided to actively investigate the taxpayers. The court nevertheless concluded that the

NBI conducted the raids for its own purposes and not for the United States.

The only direct evidence to support the taxpayers' contention that United States officials instigated, conducted or participated in the raids is the trial testimony of Damaso Nocon, a former aide to Colonel Jose Lukban, Director of the NBI. Nocon's testimony is directly contrary to the testimony of Lukban, IRS agent Robert Chandler and FBI agent Hawley. Each of them testified that the NBI did not conduct the raids for the United States or with the help of the United States.

I find that Nocon's testimony is not credible. I believe that the NBI conducted the raids for its own reasons. In 1959-60, several years before the raids, the NBI began to investigate the taxpayers and several other prominent foreign businessmen at the request of a Philippine senator. Antonio Jocom, an NBI agent, was assigned the Stonehill investigation. The object of the investigation was to deport the taxpayers because they allegedly had a corrupting influence on Philippine politics.

As part of the investigation, the NBI wiretapped the taxpayers' telephones in early 1960. During the next two years, the NBI gathered substantial information, and, when Spielman began to cooperate with the NBI in January 1962, the NBI planned the raids which took place on March 3, 1962.

[4] United States officials were interested in the fruits of those raids, but I find that they neither instigated nor directed them. The motion to suppress this evidence is denied.

B. *Suppression of Evidence from Wiretaps and "Thefts" of Documents*

The taxpayers contend that all of the Government's evidence should be suppressed because it came, directly or indirectly, from illegal wiretaps and thefts of documents. This argument, not previously urged, is based on newly discovered evidence.

The taxpayers contend that the NBI wiretapped their telephones at the request of the United States, that those wiretaps were illegal, and that all of the evidence subsequently gathered by the United States is the fruit of that illegal activity.

NBI Director Lukban testified that the NBI installed the wiretaps in the course of its own investigation of the taxpayers, without any input from the United States. FBI agent Robert Hawley, who was given some transcripts by the NBI, testified that he never asked for wiretaps or transcripts.

The only evidence which supports the taxpayers' position is the testimony of Damaso Nocon, Lukban's aide. As I said earlier, I do not believe Nocon's testimony.

The taxpayers next contend that the United States,

through Menhart Spielman, unlawfully took documents from them, and that all of the evidence subsequently gathered by the United States is the fruit of that illegal activity.

Spielman worked for the taxpayers for about two years. In March 1961, he became Executive Vice President and General Manager of United States Tobacco Corporation, one of the taxpayers' principal companies. During the fall of 1961, both taxpayers were out of the country because of controversy over their role in the on-going Philippine election campaign.

In the taxpayers' absence, Spielman secretly copied some of their records which he thought showed illegal activities. When the taxpayers returned after the election, they and Spielman quarreled; they fired Spielman. It was then that Spielman went to United States officials, told them about the taxpayers' activities, and gave them copies of many documents.

The taxpayers contend that the United States had placed Spielman in the taxpayers' business as an informer and that the documents were therefore illegally obtained.

The taxpayers' evidence, both old and new, fails to prove that Spielman was an agent of the United States when he copied the documents. I find that Spielman copied these records to force the taxpayers to give him part ownership in their business enterprises. When Spielman proposed this, they first beat him and then fired him.

Spielman became fearful of what else they might do to him, so he went to United States officials for protection and for vengeance. He also hoped to receive a reward from the United States for providing information leading to substantial income tax revenue. When United States officials became interested in his revelations, Spielman tried to bargain to get the United States Army to forgive him for his misdeeds while stationed in Tokyo.

[5] The taxpayers failed to show that their telephones were tapped at the request of the United States or that Spielman was an agent of the United States when he copied the documents. Their motion to suppress is denied.[4]

III. *Taxpayers' Due Process Motion*

The taxpayers seek a "dismissal of Plaintiff's ("Government") complaint and for judgment quashing the purported assessments and liens sought to be foreclosed" on the ground that the Government denied them due process.

When NBI agents raided the taxpayers' business premises on March 3, 1962, they seized about 35 truckloads of documents. The NBI permitted IRS agents, who were investigating the taxpayers, to copy some of those documents. During discovery in this action, the

4. *See also Stone v. Powell*, — U.S. — , 96 S.Ct. 3037, 49 L.Ed.2d —, decided July 6, 1976.

Government gave the taxpayers copies of all of its copies.[5]

The taxpayers contend that the IRS agents copied only documents which tended to support the Government's case and intentionally suppressed documents favorable to the taxpayers.

The NBI seized these records, and more than 20 NBI agents cataloged them. Although the records were under the NBI's exclusive control, it permitted IRS agents to set up a microfilm machine in the house in which the records were kept. The NBI did not, however, give the IRS agents unrestricted access to the records. The IRS agents were allowed to examine and copy only those documents which they requested and which the NBI thereafter brought to them.[6]

The IRS agents testified that they repeatedly asked the NBI agents to bring them all financial records on the taxpayers and their companies. The IRS agents "specifically mentioned bank accounts, money transfers, assets, liabilities, loans, investment and ownership in corporate and other entities." The IRS agents testified that they copied all relevant financial records

5. These documents given to the taxpayers by the Government are the only access that the taxpayers have had to most of their records since they were seized. The NBI kept most of the records and has not allowed the taxpayer to see them.

6. The IRS agents worked 12 hours a day, seven days a week, for about two and a half months, copying more than 30,000 documents.

brought to them[7] without regard to whom they favored.[8] I believe that testimony.

[6] I find that the taxpayers failed to prove that the Government intentionally suppressed any relevant documents. Their motion is denied.

IV. *Tax Liability*

The Government contends that the taxpayers increased their combined net worth by almost $16 million during the tax years 1958 through 1961. During that period, taxpayers reported combined incomes of less than $200,000. Using these net worth figures, the Government, in January 1965, assessed the taxpayers more than $14,000,000 in unpaid taxes, more than $7,000,000 in fraud penalties, and more than $3,000,000 in interest.

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7. The IRS agents undoubtedly did not receive every relevant document seized in the raids; millions of documents had to be processed hurriedly by a large number of people because the taxpayers were expected to join the examination of the records. The taxpayers did obtain an injunction a few weeks after the IRS finished most of its copying.

8. Agent Ragland testified: "During the copying process we did not have any idea of what was significant to the audit, and therefore, we were expansive in copying the documents. At this juncture we did not have sufficient knowledge to exclude any financial documents. For instance, a personal financial document indicating a liability could lead to a significant asset and additional income. Also any large asset or liability appearing in any previous year could lead us to sources of more income includible in the tax years under examination."

The taxpayers contend that the assessment is wrong and that they owe no taxes.

[7-9] In an action to collect taxes, the Government has the burden to prove the existence and amount of tax deficiency. *United States* v. *Molitor*, 337 F.2d 917, 922 (9th Cir. 1964). To meet this burden initially, the Government may introduce the notice of assessment. The assessment is presumed to be correct, and the admission of the notice of assessment establishes a prima facie case. *United States* v. *Rindskopf*, 105 U.S. 418, 422, 26 L.Ed. 1131 (1881); *United States* v. *Molitor*, *supra* at 922-23.

A. *The Government's Prima Facie Case*

The taxpayers contend that the Government failed to make a prima facie case.

They contend that the assessments, which underlie the Government's prima facie case, are improperly based on the net worth method. They contend that the Government may use net worth only if the taxpayers' records are either inadequate or do not accurately reflect the taxpayers' income. This, they assert, the Government failed to show.

[10] This contention is frivolous. The taxpayers' records available to the Government are incomplete and do not accurately reflect the taxpayers' income.[9]

The taxpayers next contend that the Government

9. See the discussion in this opinion on the fraud issue.

did not make a prima facie case because it did not introduce in evidence the notices of deficiency.

Generally, the Government begins its tax collection process by sending the taxpayer a notice of deficiency which shows the basis and the amount of tax due. 26 U.S.C. § 6212(a). But, when the "assessment or collection of a deficiency . . . will be jeopardized by delay", the Government may make a jeopardy assessment by sending notice of assessment (also called a collection notice) under 26 U.S.C. § 6303 before sending the notice of deficiency. 26 U.S.C. § 6861(a). When the Government makes a jeopardy assessment, it must also send a Section 6212(a) notice of deficiency "within 60 days after the making of the assessment". 26 U.S.C. § 6861(b).

Here, the Government initiated its collection process by issuing jeopardy assessments. At the trial, the Government introduced the notices of assessment to establish its prima facie case but did not introduce notices of deficiency.

[11] The taxpayers contend that the Government is not entitled to the presumption of correctness and did not make a prima facie case because it did not prove that it sent the notices of deficiency as required by Section 6861(b). The taxpayers rely on *United States* v. *Ball*, 326 F.2d 898 (4th Cir. 1964). There, the court held that a jeopardy assessment under Section 6861(a) is not valid without both a Section 6303 notice of assessment and a Section 6212 notice of deficiency. The

court held that the jeopardy assessment was invalid because the Government failed to prove it set the notice of deficiency.

[12] I do not believe that failure to introduce the notice of deficiency is fatal to a jeopardy assessment. In *Boren* v. *Riddell*, 241 F.2d 670, 672 (9th Cir. 1957), the court held that technical compliance with the Section 6212(a) notice requirement is not necessary if the taxpayer receives actual notice. Here, there was actual notice. The taxpayers acknowledged, at hearings and in their briefs, that they received the deficiency notices. In 1965, the taxpayers, in their petitions to the Tax Court, acknowledged receipt of the notices of deficiency. Furthermore, the Ninth Circuit Court of Appeals has stated that in a jeopardy assessment case the only purpose of the notice of deficiency is to start the time running within which the taxpayers can petition the Tax Court; even an improper notice of deficiency does not render the underlying jeopardy assessment invalid. *Cohen* v. *United States*, 297 F.2d 760, 773 (1962).

I therefore hold that the Government has made a prima facie case.

B. *The Taxpayers' Burden*

The Government contends that the taxpayers have the burden to prove that the Commissioner's determination of tax deficiency is erroneous and that the burden is on the taxpayers to prove that they owe no taxes.

The taxpayers, on the other hand, contend that their only burden is to prove that the Commissioner's determination is significantly incorrect. The taxpayers also contend that when they do that, the Government may no longer rely on the presumption of correctness, but must prove the existence and amount of tax deficiency.

There appears to be a conflict in the cases on burdens of proof, but the conflict is more apparent than real and results from imprecise language in the opinions. I believe that the cases are generally reconcilable and that the correct rule and the proper procedures are set forth in Mertens, Law of Federal Income Taxation:

> In an action by the Government for the collection of a tax, the burden of proof is upon the United States under the familiar rule that he who alleges, must prove. This burden is initially met, however, merely by proof that the tax liability has been assessed against the defendant; and this is usually done by introducing into evidence a certified copy of the assessment list. A prima facie case is thus established, and the defendant must go forward with his defense. In order to rebut the prima facie case established by the assessments made against the taxpayer, it is necessary to show, by a preponderance of the evidence, that the assessments were incorrect . . . If the assessment has not been the subject of an adjudication, and the Government sues to reduce it to judgment, the taxpayer may contest the correctness of the assessment in that action, and will in effect have to assume the burden of proof on that issue. In such a case, however, if the taxpayer is successful

> in proving by a fair preponderance of the evidence that the assessment is erroneous, the burden shifts to the Government to prove whether any deficiency exists and, if so, in what amount. 9 Mertens, Law of Federal Income Taxation § 49.218 (April 1976) (footnotes omitted).

Rockwell v. *Commissioner*, 512 F.2d 882 (9th Cir. 1975), upon which the Government strongly relies, does not require a different result. That case involved disputed income tax deductions, and the court expressly distinguished deduction cases from those, like this one, involving unreported income. *Supra* at 886.

[13] I therefore hold that the taxpayers have the burden of going forward with the evidence and the burden of proving that the Government's assessments, which underlie the prima facie case, are incorrect. If the taxpayers succeed, the burden then shifts to the Government to prove the receipt of unreported income and also the amount of that income. If the Government fails to meet that burden, it cannot prevail.

The taxpayers contend that they proved numerous errors in the Government's assessments. They therefore assert that the presumption of correctness is not available to the Government. The Government denies these contentions, and it argues that even if the taxpayers show that some parts of the assessments are erroneous, the presumption survives for other parts.

[14] In my view, when an assessment has separable parts, the taxpayer has the burden to discredit each

part, and the presumption survives for each part that the taxpayer fails to discredit. If, however, the errors show a pattern of carelessness or arbitrariness by the Commissioner, the presumption disappears for the entire assessment. *Clark* v. *Commissioner*, 266 F.2d 698, 707 (9th Cir. 1959); *Hoffman* v. *Commissioner*, 298 F.2d 784, 788 (3d Cir. 1962); *Foster* v. *Commissioner*, 391 F.2d 727, 735 (4th Cir. 1968); *Anderson* v. *Commissioner*, 250 F.2d 242, 246 (5th Cir. 1957).

[15] This approach is particularly applicable in net worth cases when the Government must determine the taxpayer's unreported income by indirect evidence. As Judge Blackmun (now Mr. Justice Blackmun) said in *Banks* v. *Commissioner*, 322 F.2d 530, 548 (8th Cir. 1963), "Some error in any net worth construction is perhaps to be expected. It is only a 'reasonable certainty' which is required by [*Holland* v. *United States*, 348 U.S. 121, 132, 75 S.Ct. 127, 99 L.Ed. 150 (1954)] and its companion cases." A taxpayer should not be able to discredit all of the Commissioner's determination by showing a few errors when the Commissioner was compelled to use the imprecise net worth method because of the taxpayer's own inadequate, unreliable or fraudulent record-keeping. "[S]kilful concealment [cannot become] an invincible barrier to proof." *United States* v. *Johnson*, 319 U.S. 503, 518, 63 S.Ct 1233, 1240, 87 L.Ed. 1546 (1943); *Banks*, *supra* at 547.

[16] I therefore hold that each part of the Commissioner's determination is entitled to the presumption

of correctness unless the taxpayers prove either that that part of the assessment was wrong or arbitrary or that the entire assessment was arbitrary.

C. *The Evidence on Tax Liability*

The taxpayers contend that the Commissioner's determination of tax deficiency is not entitled to the presumption of correctness because it is arbitrary and incorrect.[10]

1. *The Community Property Issue*

During the tax years, both taxpayers were married to Philippine citizens. The taxpayers contend that, under Philippine community property law,[11] one-half of most of their income during the tax years belonged

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10. Because the Government relied on the presumption of correctness, it did not introduce evidence to prove each item of unreported income. In its post-trial brief, however, the Government sought to use evidence submitted for a limited purpose to support the correctness of the Commissioner's determination.

The taxpayers moved to strike parts of the Government's brief asserting that the Government incorrectly relied on evidence which had been admitted solely on the issue of fraud.

I will not discuss each objection. I merely repeat what I said at the trial. The Government may rely on any evidence to defend the integrity of the Commissioner's determination against the taxpayers' attacks. The Government may not, however, rely on evidence admitted on the issue of fraud to prove specific items of tax liability.

11. The terms "community property" and "conjugal partnership" are used interchangeably because here they have the same meaning.

to their wives, whose incomes are not subject to United States income taxes. The taxpayers therefore argue that the Commissioner's determination of taxable income is not entitled to the presumption of correctness because it includes their wives' share of the community income.

[17] The Government conceded before trial that the taxpayers "should be taxed on only one-half the income of the conjugal partnership". The Government contends, however, that this error in the Commissioner's determination does not destroy the presumption of correctness for the entire assessment. I agree.

The Commissioner's decision not to apply Philippine community property law to reduce the taxpayers' taxable income involved difficult issues both on the law of conflicts and on the law of Philippine community property. Even the taxpayers' expert on Philippine law testified that the community property issue was "sticky", and the taxpayers acknowledge that experts "differ quite a bit" on the issue. Furthermore, the taxpayers did not make community property claims for their wives in their income tax returns before 1962.

I therefore find that the Commissioner's determination on community property, although incorrect, was reasonable. This error does not prove carelessness or arbitrariness in making the assessment. I therefore hold that the Commissioner's determination, as modified by community property considerations, continues to be entitled to the presumption of correctness.

2. *Opening Net Worth*

The Commissioner used the net worth method to compute the taxpayers' income. The taxpayers contend that the Commissioner's determination of income is overstated because the opening net worth figures of $687,640.90 for Stonehill and $219,782.97 for Brooks are grossly understated.

The taxpayers first contend that the Commissioner "ignored uncontradicted evidence of substantial cash on hand" at the beginning of the tax years when he determined that Stonehill had only $3,904.50 in cash and Brooks had only $31,049.37 in cash. The taxpayers argue that, considering their methods of operation and the size of their business enterprises, those opening cash figures are unrealistic and unreasonable.

The taxpayers rely on *Gunn* v. *Commissioner*, 247 F.2d 359, 362-365 (8th Cir. 1957). There the Commissioner determined that the taxpayer had no cash at the beginning of the tax period. The taxpayer introduced extensive evidence, including testimony by his bookkeeper, his banker, and his accountant, to show that he always had considerable cash on hand for use in his business of buying produce from farmers and selling it to canneries. The bookkeeper testified that the taxpayer regularly kept $2,500 to $5,000 on hand. The court held that, in light of the taxpayer's business history and practice, the Commissioner's determination was unrealistic. The court reversed and remanded for additional hearings.

The taxpayers also rely on *Potson* v. *Commissioner*, 22 T.C. 912, *aff'd sub nom. Bodoglau* v. *Commissioner*, 230 F.2d 336 (7th Cir. 1956), and *Thomas* v. *Commissioner*, 232 F.2d 520 (1st Cir. 1956). In each of these cases, the court held that the Commissioner's determination of opening net worth was wrong because there was substantial evidence showing that the taxpayer had much more cash on hand than the Commissioner's figures showed. In each case, the taxpayer estimated how much cash he had.

Here the Commissioner was faced with many obstacles in his attempt to find all of the taxpayers' opening assets. The taxpayers' business enterprises were complex and widely scattered. Much of the Commissioner's investigation of the taxpayers took place in foreign countries. The taxpayers' records did not accurately reflect their financial operations, and the Commissioner did not have complete access to those records.

[18] Under these circumstances, the Commissioner should not be faulted for his failure to speculate on the amount of additional cash and other assets which the taxpayers may have secreted. In my view, the Commissioner made a reasonable and conscientious effort to find all of the taxpayers' opening assets, and he followed all reasonable leads to obtain such information. When, as here, records are inaccurate and assets concealed, the burden should be and I believe is on the taxpayers to prove the existence and the approximate amount of that cash.

The taxpayers did not meet that burden. Unlike the cases upon which they rely, the taxpayers did not provide any credible evidence on the amount of cash they had at the beginning of the tax period. That evidentiary deficiency was not overcome by a statement from a former employee that in the early 1950's the taxpayers used a great deal of cash in their businesses and that between 1957 and 1962 they illegally sent large amounts of cash to accounts outside of the Philippines. Neither is that deficiency overcome by evidence that in 1957 and 1958 they paid 10 million pesos in cash to high Philippine officials for an exclusive trade permit for the importation of American tobacco. This general evidence shows that at different times the taxpayers did have large sums of cash on hand, but it does not show that on December 31, 1957, the date of the opening net worth, the taxpayers had more cash on hand than was credited to them by the Commissioner. It is just as reasonable to believe that on that date the taxpayers, who had just paid 10 million pesos in cash, were short of cash.

[19] The taxpayers, who might have shed light on their cash position, refused to testify either in person or by deposition. When a party who has special information relevant to his case refuses to testify, the Court may infer that his testimony would be unfavorable to his case. *Stoumen* v. *Commissioner*, 208 F.2d 903, 907 (3d Cir. 1953); McCormick, Evidence § 272 (2d ed. 1972).

[20] I therefore hold that the taxpayers have not met their burden to prove that the Commissioner's determination on the cash they had on hand on December 31, 1957, was either incorrect or arbitrary.

The taxpayers next contend that the Government improperly excluded a major asset from their opening net worth.

In late 1957, the taxpayers made payments totalling 10 million pesos[12] in cash, to high Philippine officials in return for a tobacco barter permit.[13] Until that time, United States tobacco, which was in great demand, could not be imported into the Philippines. The barter permit was the only barter permit for United States tobacco issued by the Philippine government and gave the taxpayers a monopoly on the importation of United States tobacco.

The taxpayers paid for the permit with personal funds, but the permit was formally issued to Philippine Tobacco and Flue-Curing Company (PTFC).[14]

12. At the official currency conversion rate, this was about $5,000,000. At the black market rate, it was about $3,000,000.

13. Some of these payments may have been made in early 1958. Under the Government's theory, the exact date is immaterial.

14. PTFC is a publicly-owned Philippine corporation which grows, processes and stores locally grown tobacco. About one-half of all tobacco grown in the Philippines was processed or stored by PTFC. Stonehill and Peter Lim organized PTFC in 1950; each owned 50 per cent of the stock. PTFC went public about 1953. During the tax years, Stonehill was the president and managing director and owned some stock.

The principal beneficiary of the permit was United States Tobacco Company (USTC)[15] which bought and used most of the imported tobacco to make cigarettes. Universal New York, Inc. (UNY)[16] was designated foreign supplier of the tobacco for importation under the permit.

The taxpayers contend that the 10 million pesos paid for the barter permit should have been "reflected in accounts receivable *from* the corporations or as capital investments *in* the corporations . . ." emphasis in original) The Government contends that the payment was not included in the opening net worth because it was a personal expenditure.

[21] I agree with the taxpayers. The taxpayers "bought" the barter permit because they expected it to generate income and profits from the importation of

15. USTC is a Philippine corporation which manufactures cigarettes. Its principal brands, Old Gold and Kent, are manufactured under a franchise from P. Lorillard Company. Stonehill organized USTC in 1950. Until December 31, 1958, Stonehill owned 65 per cent of the stock. After that date, Stonehill owned 50 per cent and Brooks owned 35 per cent of the stock. During the tax years, Stonehill was chairman of the board, and Brooks was president and general manager. USTC is now known as Quality Tobacco Corporation.

16. UNY is a New York corporation in the import-export business. It was organized in 1947 by Ira Blaustein, a business associate of Stonehill, to be Stonehill's representative in the United States. UNY represented several of Stonehill's enterprises, including PTFC and USTC. After 1950, Stonehill owned 55 per cent of the stock, Blaustein owned 25 per cent, and Brooks owned 10 per cent.

United States tobacco and the sale of cigarettes made from that tobacco. The payment may have been immoral and illegal, but it was a business investment, not a personal expenditure.

Nevertheless, the Commissioner's erroneous exclusion of this asset from the opening net worth does not destroy the presumption of correctness for the entire assessment.

The 10 million peso payment for the permit was an unusual transaction which raised unusual problems for the Commissioner. First, the transaction was illegal. Second, the transaction was not reflected on the books of any of the taxpayers' corporations. Third, the Commissioner's determination that the payment was a personal expenditure was reasonable, although I now conclude that it was not a personal expenditure but a business investment.

I therefore hold that the Commissioner's determination must be modified by adding 10 million pesos to the taxpayers' opening net worth as either an account receivable or a capital investment. The pesos should be converted to dollars at the same rate of exchange that the Government used when it computed the taxpayers' income for the tax years 1958 through 1961.

The taxpayers next contend that the Commissioner understated the value of an asset included in the opening net worth.

At the beginning of the tax period, both taxpayers

owned stock in United States Tobacco Company (USTC). To determine the amount of the taxpayers' investment in that stock, in pesos, the Commissioner relied on reports required to be filed by USTC with the Philippine Securities and Exchange Commission (the PSEC). The Commissioner then converted the pesos to dollars at the black market rate of 3.54 pesos to the dollar.

The taxpayers contend that the Commissioner should have obtained his figures from USTC's accounting reports rather than from the PSEC reports and that the Commissioner should have used the official conversion rate of two pesos to the dollar.

[22] The Commissioner's use of the PSEC figures was proper. The taxpayers cannot now complain about the inaccuracy of figures that they themselves submitted to an official Philippine government agency. Furthermore, the Commissioner's distrust of the company's accounting reports was justified. The taxpayers have frequently acknowledged that the company's records did not fully reflect its operations, and the Government's evidence proves it.

[23] The Commissioner's use of the black market conversion rate was also proper. The taxpayers used that rate on their income tax returns, and they were not prejudiced because the Commissioner used the same conversion rate at both the beginning and the end of the tax period.

3. *Increases in Net Worth*

The Commissioner determined that during the tax years 1958 through 1961 Stonehill's net worth increased about $8,330,000 and Brook's about $7,560,000. The taxpayers contend that the Government did not prove "a likely source" for those net worth increases as required by *Holland* v. *United States*, 348 U.S. 121, 75 S.Ct. 127, 99 L.Ed. 150 (1954).[17]

The taxpayers assume that *Holland* is applicable here even though it was a criminal case. The Government does not discuss whether *Holland* is applicable to a civil tax case or whether the presumption of correctness makes it unnecessary to show a likely source for net worth increases from current taxable income. It is unnecessary for me to decide that issue because I believe the evidence here establishes likely sources.

[24, 25] The taxpayers received large kickbacks through UNY, and they received unreported dividends and interest from investments made even during the tax years. There was also evidence that the taxpayers

17. In *Holland*, the Supreme Court said:

> ". . . [R]equisite to the use of the net worth method is evidence supporting the inference that the defendant's net worth increases are attributable to currently taxable income.
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> . . . Increases in net worth, standing alone, cannot be assumed to be attributable to currently taxable income. But proof of a likely source, from which the jury could reasonably find that the net worth increases sprang, is sufficient. . . ." *Supra* at 137-138, 75 S.Ct. at 136.

siphoned large sums of money from USTC,[18] PTFC and numerous other business enterprises which they controlled and that they got kickbacks from Philippine cigarette manufacturers who bought imported tobacco through PTFC. These are "likely sources"; ". . . the Government is not required to negate every possible source of nontaxable income, a matter peculiarly within the knowledge of the [taxpayer]." *Holland, supra,* at 138, 75 S.Ct. at 137.

[26] The taxpayers next contend that the Commissioner improperly increased their closing net worth by erroneously and arbitrarily increasing the amount of their investment in USTC.

Before and during the tax years, the Philippine government had strict currency restrictions. Pesos could be sent out of the country only with the approval of the Central Bank.

During the tax years, the taxpayers regularly sent large sums of pesos out of the Philippines through black market money exchangers. Much of this money was deposited in Swiss bank accounts to the credit of the taxpayers and later used for Philippine companies owned or controlled by the taxpayers.

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18. There was evidence that USTC evaded Philippine cigarette revenue taxes by illegally purchasing some revenue stamps from the printer who supplied the Philippine government with these stamps and that, through unreported sales of cigarettes with these illegal stamps, USTC generated large sums of unreported cash.

In 1958, the taxpayers obtained the tobacco barter permit. The permit was issued to PTFC; it allowed PTFC to import 10,000,000 pounds of United States tobacco on the condition that PTFC export 14,000,000 pounds of Philippine tobacco.[19] The principal beneficary of the permit was USTC; it bought most of the imported tobacco to make cigarettes. In the first 15 months after USTC began to receive United States tobacco for use in its cigarettes, its share of the Philippine cigarette market jumped more than 1500 per cent — from 3.7 per cent to 58 per cent. UNY was the export agent for the United States tobacco which was imported into the Philippines.

Under the permit's currency restrictions, PTFC could spend, through the Central Bank, only $4,900,000 for the United States tobacco, or an average of 49 cents a pound. United States tobacco cost more than 49 cents a pound; it averaged about 75 cents a pound. The taxpayers had to find ways, outside official currency channels, to get the extra funds to UNY in the United States. They sent most of the money through their Swiss bank accounts. UNY obtained additional money in the United States through profits and various special arrangements. For example, UNY required United States tobacco companies to pay it a 3 per cent com-

19. The theory of the barter permit was that the currency derived from the exported Philippine tobacco would be about the same as that expended on the imported United States tobacco. That was not the case. United States tobacco cost about three or four times as much as Philippine tobacco.

mission on all tobacco exported to the Philippines; UNY also received a $12 per ton freight differential on tobacco shipped to the Philippines.

When UNY received an invoice from a United States tobacco company for tobacco shipped to the Phiippines, UNY billed the Philippine purchaser, usually USTC, about 49 cents a pound, although the actual purchase price averaged about 75 cents a pound. To make up the difference, the taxpayer sent money to UNY from their Swiss bank accounts. On its books, UNY credited the money from the Swiss accounts to USTC. There were no complementary entries on USTC's books.

The taxpayers used the same unofficial channels to buy machinery and supplies, such as cigarette paper and filters, for USTC and to pay royalties to P. Lorillard Company on USTC's behalf. During the tax years, the credits to USTC's account at UNY from money going through unofficial channels totalled about $5 million.

The taxpayers also used money from their unofficial channels to buy real estate and securities in the United States. Some of that is the property upon which the Government asserts the liens that it seeks to foreclose in these proceedings.

When the Commissioner computed the value of the taxpayers' closing assets here, he treated the payments through unofficial channels for USTC's account as

capital contributions by the taxpayers to USTC. The value of the taxpayers' investment in USTC and their closing net worth were thereby increased by about $5 million.

The taxpayers contend here that this increase in their net worth was improper. They first contend that the money sent from the Philippines to UNY was corporate rather than personal money. In the alternative, they contend that, if the money did belong to them, it was money they had on hand before the beginning of the tax period rather than from current taxable income.

In the assessment, the Commissioner determined that the money belonged to the taxpayers personally and that it was from current taxable income. His determinations are presumed to be correct, and the taxpayers have the burden to prove that the determinations are wrong. The taxpayers have failed to meet their burden.

[27] The principal test of income tax liability is control or command over the property received. As the court stated in *Corliss* v. *Bowers*, 281 U.S. 376, 378, 50 S.Ct. 336, 337, 74 L.Ed. 916 (1930). "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not." *See also Burnet* v. *Wells*, 289 U.S. 670, 678, 53 S.Ct. 761, 77 L.Ed. 1439 (1933); *Helvering* v. *Horst*, 311 U.S. 112, 118-119, 61 S.Ct. 144, 85 L.Ed. 75 (1940).

[28] When a controlling stockholder-officer diverts corporate money to his personal control, that money is taxable as a constructive dividend. *Dawkins* v. *Commissioner*, 238 F.2d 174, 178 (8th Cir. 1956); *Hartman* v. *United States*, 245 F.2d 349, 352-353 (8th Cir. 1957).

Here, funds in the Swiss bank accounts belonged to the taxpayers personally and not to their corporations. Although the taxpayers chose to invest some of those funds in USTC by paying some of USTC's bills, the taxpayers could and did spend much of it for their own use; they invested more than $4 million in real estate and securities in the United States.

The taxpayers considered the Swiss bank accounts as their personal accounts. Stonehill and Brooks had separate accounts which were under their individual control. In correspondence, they referred to these accounts as "my account." Stonehill, his wife, and his father executed signature cards which were placed in a sealed envelope and left with bank officials in New York so that in an emergency his wife or father could dispose of securities which Stonehill had purchased with funds from the Swiss accounts.

I find that the money in the Swiss bank accounts belonged to the taxpayers personally.

The taxpayers contend that any money in the Swiss accounts found to belong to them was money that they had before the beginning of the tax years. They failed to prove it.

The taxpayers next contend that part of the money in the Swiss bank accounts came from the repayment by USTC of the 10 million pesos used to obtain the barter permit. Assuming that to be true, the taxpayers, after being credited with $3 million[20] for that repayment, failed to account for an additional $6 million which went into these accounts.

I hold that the Commissioner properly increased the taxpayers' investment in USTC by approximately $5 million, the amount the taxpayers expended for USTC in the United States through unofficial channels.

I also hold that the Commissioner's determinations of tax deficiencies, as modified by this opinion, are correct and not arbitrary. The Government is therefore entitled to judgments against the taxpayers for tax deficiencies.

V. *Fraud*

The Commissioner assessed fraud penalties of 50 per cent of the taxpayers' tax deficiencies.

[29] "If any part of any underpayment . . . of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. . . ." 26 U.S.C. § 6653(b). "The burden is on the Commissioner to establish by clear and convincing evidence that at least some part of the

20. The black market equivalent for 10 million pesos.

deficiency was due to fraud." *Clark* v. *Commissioner*, 266 F.2d 698, 717 (9th Cir. 1959).

The taxpayers assert that, even if they failed to report and pay taxes on substantial amounts of income, the Government did not prove that this failure was the result of their wilful atempt to evade taxes. I disagree.

During the tax years, both Stonehill and Brooks opened and maintained a number of Swiss bank accounts, several in the names of Liechtenstein establishments or limited companies organized to conceal the fact that they were the real depositors. Whenever one of these Liechtenstein entities became known as a vehicle for the taxpayers, they dissolved that entity and transferred the assets to a new one which they organized.

The taxpayers sent money to these Swiss accounts from the Philippines through black market currency channels. They also sent money from UNY, which was realized from freight differentials and commissions. During the tax years, they sent more than $9 million to Swiss accounts. They later used some of this money to pay bills for USTC. They also used the money to buy real estate and securities for themselves in the names of United States corporations which they organized and which they used to conceal the source of some of the funds.

[30] The taxpayers engaged in elaborate, devious

and complicated transactions through business entities often organized by persons whom the taxpayers arranged to front for them. They also engaged in the other activities described in earlier portions of this opinion. The taxpayers admit that they engaged in many of these activities to evade Philippine currency restrictions and perhaps even Philippine taxes, but they deny that they attempted to evade United States income taxes. I do not believe that their actions can be so limited. I hold that the Government established by clear and convincing evidence that the taxpayers willfully attempted to evade income taxes due the United States government.

The following excerpt from *Spies* v. *United States*, 317 U.S. 492, 499, 63 S.Ct. 364, 368, 87 L.Ed. 418 (1943), is particularly appropriate here:

> Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation. Nor would we by definition constrict the scope of the Congressional provision that it may be accomplished "in any manner". By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely

effect of which would be to mislead or to conceal. If the tax-evasion motive plays any part in such conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime.

The Commissioner properly assessed and added to the amount of taxpayers' deficiencies fraud penalties of 50 per cent of these tax deficiencies.

VI. *Conjugal Property*

During the tax years, the wife of each of the taxpayers was a Philippine citizen. The taxpayers' wives, who were joined as defendants in this action, assert interests in the property which the Government seeks to foreclose here.

The wives contend that this property, which their husbands acquired during their marriage, is conjugal property[21] and that the husbands' tax liabilities cannot be satisfied out of the wives' share of the conjugal property.[22] Specifically, they assert that, as Philippine

21. The parties here acknowledge that Philippine community property law is based on "conjugal partnership of gains" and that community property is called "conjugal property".

22. The wives contend that some of the property is their "exclusive property", Civil Code Ann., Art. 148, because it is registered in their names. I disagree. Any property acquired during marriage with conjugal funds remains conjugal property no matter which spouse is recorded as the owner. *Romero de Pratts v. Menzi & Co. and Sheriff of Rizal*, 53 Phil. 51 (1929). The wives do not contend that any of the conjugal property was bought with funds that they had before they married the taxpayers or which they acquired by inheritance or gift.

citizens, they do not owe any United States income taxes and that the taxes which their husbands owe are personal rather than conjugal debts. I disagree.

Article 161 of the Philippine Civil Code Annotated (Padilla 6th ed., 1971) provides: "The conjugal partnership shall be liable for: (1) all debts and obligations contracted by the husband for the benefit of the conjugal partnership. . . ."

[31] Under both this statute and Philippine case law, the debts incurred by a spouse while trying to increase the conjugal property are charged to the conjugal partnership, *Javier* v. *Osmena*, 34 Phil. 336 (1916), even if the other spouse opposes the enterprise. *Abella de Diaz* v. *Erlanger & Galinger, Inc.*, 59 Phil. 326 (1933). As Scaevola, an eminent Spanish commentator, said: ". . . the legal rule that he who shares in the profits, must share in the losses, governs in all its extent; hence the supposition that the husband should pay [expenses incurred to produce income] out of his separate property and in return share the gains obtained with his wife, would be entirely absurd and contrary to all long established principles concerning a partnership." 22 Scaevola, Codigo Civil, p. 246 (1905); *de la Torre* v. *National City Bank of New York*, 110 F.2d 976, 979 n. 2 (1st Cir. 1940).

[32] The community property law of the State of Washington is substantially the same as that of the Philippines. *Helvering* v. *Campbell*, 139 F.2d 865, 870 (4th Cir. 1944). The Washington Supreme Court in

Hearron v. *Severyns & Co.*, 159 Wash. 486, 488, 293 P. 458 (1930), said: "We have here, then, the familiar case of an act done by the husband in the interest of the community and from which it derived a direct benefit. In all such cases we have invariably held the community liable, and the cases on the subject are so numerous and the rule so familiar that we refrain from citing authority."

[33] Here, the taxpayers' business enterprises during the tax years increased the conjugal property, and the wives shared in that increase. The taxpayers' United States income taxes are obligations incurred in connection with the acquisition of the additional conjugal property, and their tax liabilites may be satisfied from the wives' share of that property.

This opinion shall constitute findings of fact and conclusions of law pursuant to Fed. R. Civ. P. 52(a).

Counsel for both the Government and the taxpayers shall compute the taxes and penalties due the United States; they shall also submit a judgment in accordance with this opinion.